MOODY'S
INVESTORS SERVICE

SPECIAL COMMENT

Why Some California Cities Are Choosing Bankruptcy

Table of Contents:

SUMMARY 1
ECONOMIC AND FINANCIAL DISTRESS HAS BEEN PARTICULARLY GREAT IN MANY CALIFORNIAN CITIES 3
PROPERTY AND SALES TAX REVENUE DECLINES HAVE BEEN SEVERE 4
GENEROUS LABOR CONTRACTS AWARDED IN BOOM TIMES HAVE PROVEN HARD TO REVERSE 6
FISCAL GOVERNANCE PRACTICES IN CALIFORNIA ALSO SUBSTANTIALLY INCREASE BONDHOLDERS' RISK OF DISTRESSED EXCHANGES AND BANKRUPTCIES 6
RATING IMPLICATIONS 9
EXPECTED TIMELINE 9
CONCLUSION 9
APPENDIX – MOODY'S CURRENT RATINGS ON CALIFORNIA LOCAL GOVERNMENTS 10

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Summary

The recent increase in bankruptcy filings and defaults in California has root causes in the boom-bust real estate economy, as well as the state's hands off "home rule" policy, the ability of public sector unions to obtain generous settlements and benefits during the good times, the inability to raise taxes without voter approval, and the new law passed by the state that "paves the pathway" to bankruptcy court for stressed municipalities. California cities have been especially vulnerable to these risks, particularly those in the inland cities within the Inland Empire and Central Valley where cheap financing and speculative residential and commercial development during the boom years resulted in high foreclosure rates and depressed prices. The depressed housing market has also significantly affected property tax revenues, since Proposition 13, the state's constitutional property tax limitation, restricts the ability of municipalities to adjust tax rates, thereby capping property tax revenues at a time when flexibility is most needed.

The US municipal marketplace is large and varied market with debt issuers that are both rated and unrated. The rated marketplace for state and local governments has historically been characterized by low default rates and relatively stable finances. These characteristics are being challenged and may be changing in the highly stressed current fiscal and economic environment across the US, and particularly in California. The unrated marketplace consists of debt issuers that are generally smaller and weaker or have non-traditional revenue pledges, many of which would not be investment grade if rated. While our comments about the changed legal, fiscal and economic environment apply to all cities in the state, our analysis and assessment of outcomes will apply to rated cities only. We expect, instances of bankruptcy and default to be higher among these unrated entities.

In October 2011, the state passed a law called AB506 that established a 60-day mediation process as a precondition to filing for bankruptcy. This law is already being utilized as there are currently several distressed California cities exploring budget solutions through Chapter 9 bankruptcy. This report details our views on the fiscal, economic and structural environment for California cities, prospects for future default and bankruptcy as well as potential rating implications for this group of credits given the challenging environment.

To summarize, we expect:

» A continuation of fiscal stress for most California communities resulting in further service reductions and pressure to reconsider existing labor agreements as well as provide significantly less generous terms in future agreements;

» More bankruptcy filings and bond defaults among California cities reflecting the increased risk to bondholders as investors are asked to contribute to plans for closing budget gaps, however, we expect the number of filings and defaults will be low relative to the 93 Moody's rated and 389 unrated city credits in California;

» Uncertain outcomes of the mediation and bankruptcy processes in terms of cost, timeliness, and results since these processes are generally untested and just beginning;

» A sharper distinction by investors and in ratings between secured General Obligation debt in California and unsecured "general fund" obligations, including lease debt and pension obligations; and

» Rating management to reflect backdrop of institutional weakness, current financial and economic pressures and evolution of the behavior by select issuers which may indicate of a shift in philosophy of payment of debt. This will include a review of the overall rating distribution of California cities and may result in across the board rating changes and/or more aggressive adjustment of ratings for California cities in distress to reflect the heightened risk of bankruptcy and default relative to cities in other states.

The cities of Vallejo, Stockton, and San Bernardino have filed for bankruptcy, and they each struggled with rapidly rising costs of labor agreements and pension costs. After years of downsizing and service reductions, elected officials report that they could not manage their finances without the ability to undo labor contracts and restructure debt service payments. This inability and unwillingness to honor obligations to bondholders is relatively new in modern day US public finance and still remains rare.

The number of governments resorting to default and bankruptcy remains very small relative to the total of 8,500 US local governments that we rate, and is even less numerous relative to the roughly 90,000 rated and unrated municipalities across the US. We expect the vast majority of rated municipalities that are under distress in California and across the nation will not resort to bankruptcy. Instead, despite their financial pressures, they will utilize combinations of spending cuts, service reductions, tax increases, and reserve draw-downs. Nonetheless, we expect to see a greater share of defaults and bankruptcies occurring in California than elsewhere in the country.

Some cities have utilized the tools of "emergency" declarations to manage these burgeoning costs, and in off-election years, put tax increase measures on the ballot. Under state law, if a municipality declares a emergency it may impose terms on labor that would not otherwise be allowed in their labor agreements. These declarations have generally been termed "fiscal emergencies", which has been utilized by many California cities, including the cities of Los Angeles and San Jose, over the years to help control costs and balance their budgets.

A growing number of stressed cities, in California and across the nation, have declared fiscal emergency or taken equivalent measures in an attempt to increase leverage to reopen labor contracts and reduce payroll, pensions and other financial contracts. The most severely distressed municipalities – a small albeit rising number – are looking to manage debt and other financial contracts through more aggressive steps such as receivership, mediation, bankruptcy and default. In the current environment, as more municipalities approach the economic or political limit to raising taxes or adjusting spending, we expect an increase in defaults and bankruptcies over the next few years.

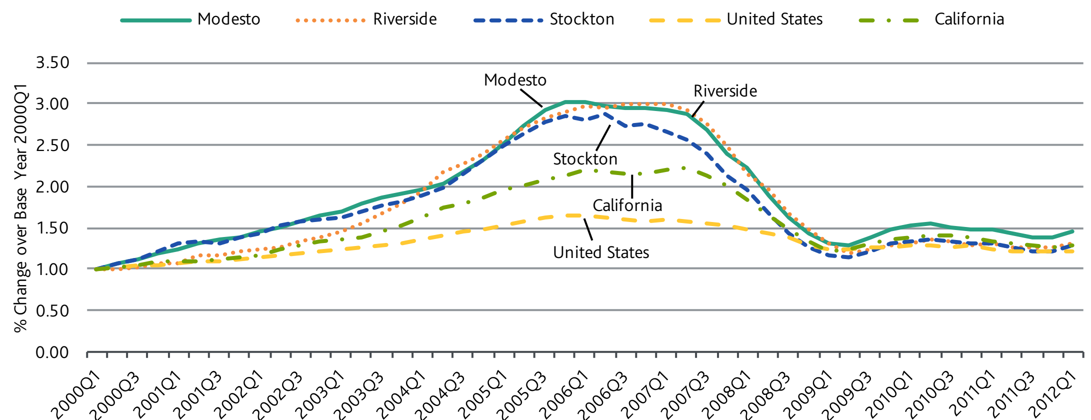
Economic and Financial Distress Has Been Particularly Great in Many Californian Cities

Real Estate Cycle In Inland California Has Been Among The Most Pronounced In The Country

Five years after the housing price bust, home prices in most of the hardest hit California regions have stabilized but have not yet begun to increase. It will likely be many years before they return to previous highs.

EXHIBIT 1

Inland Cities Suffer Large Housing Price Declines

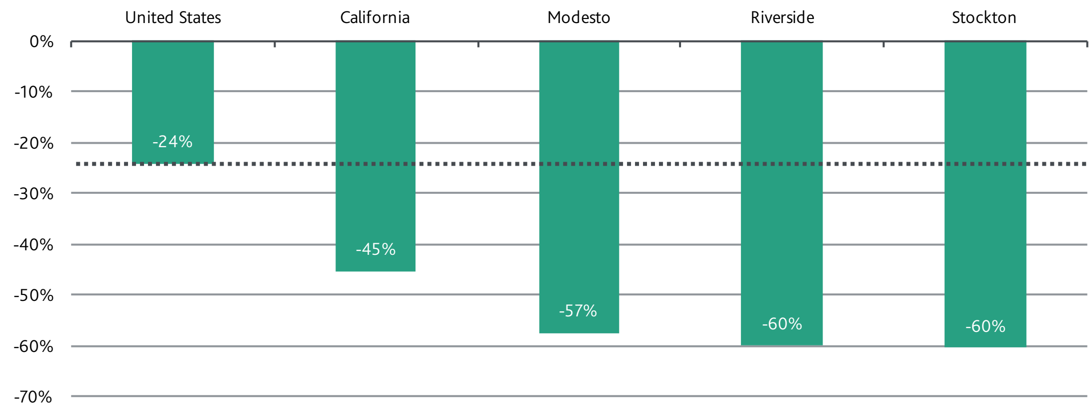


Source: National Association of Realtors (NAR): Real Estate Outlook

Housing prices in California rose rapidly during the boom period from 2001-07, with prices in the Inland Empire and Central Valley growing even more rapidly as these areas, unlike the coast, had substantial available land and few growth controls. These inland areas were much harder hit over the economic downturn that began in 2008 as peak to trough house price declines far exceeded the statewide and national average (Exhibit 1).

EXHIBIT 2

Peak to Trough Change in Housing Prices, 2005 to 2010



Source: National Association of Realtors (NAR): Real Estate Outlook

Home prices across the country suffered a 24% peak to trough decline, while Californians generally experienced a 45% decline. By comparison, the inland cities of Stockton, Riverside, and Modesto had price declines averaging about 60% (Exhibit 2), leaving many homeowners with negative equity as the value of their homes fell below their outstanding mortgages. Foreclosure rates escalated as mortgage costs soared when variable borrowing rates reset higher. Foreclosure rates in these areas are about 3 to 4 times higher than the US.

Other parts of the state did not experience as great a decline as the inland areas. The densely populated coastal regions of the state including San Diego, Los Angeles and San Francisco, experienced peak to trough declines consistent with the California statewide average. These cities have more recently seen rebound in housing sales and prices, unlike the inland cities.

EXHIBIT 3

Foreclosure Rates as of 1Q 2012

	Foreclosure Rate
United States	**0.4%**
Modesto	1.7%
Riverside	1.6%
Stockton	1.7%
Fresno	1.1%

Source: RealtyTrac Metropolitan Foreclosure Market Report

Property And Sales Tax Revenue Declines Have Been Severe

Two of the largest revenues sources for Inland Empire cities are sales and property taxes. The weak economies in these cities has caused revenue weakness in these two key revenues sources. The Inland Empire cities have fared worse than the coastal cities in California, accounting for the more severe fiscal and credit issues in these areas. While sales taxes have begun to recover, property taxes continue to reflect the very weak housing market and the prospect that high foreclosure rates will continue to exert downward pressure on housing prices and assessed value.

EXHIBIT 4

California Aggregate Sales Tax Collection

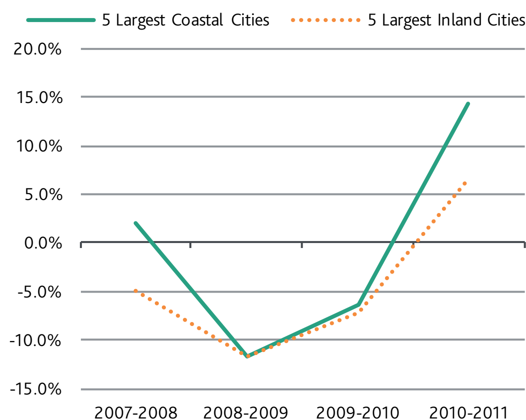
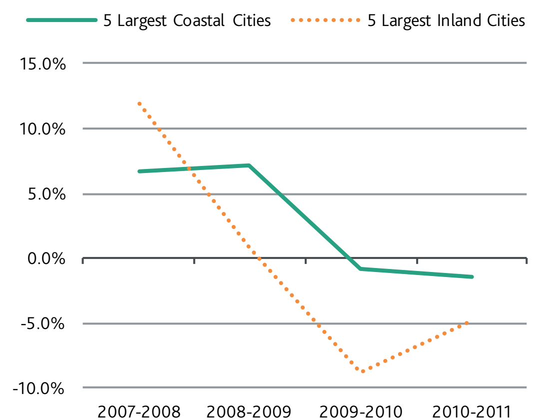


EXHIBIT 5

California Aggregate Property Tax Collection



Source: 2011 city consolidated annual financial reports; 2012 City of Stockton Proposals for Modifications to Obligations Under AB 506 Process Estimates

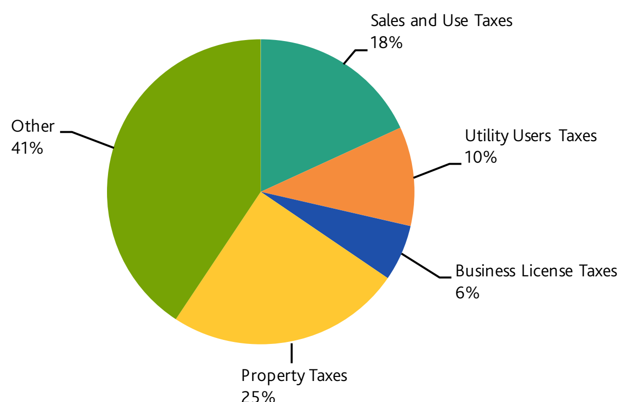
The boom-bust portions of the state did not benefit from California local governments' historical stability of real property tax collections, especially in comparison to older, more built-out parts of the state along the coast. With so many homes changing hands in the inland areas, both newly build and existing homes, a much larger portion of these inland cities' properties were valued at their true market values rather than at the lower values imposed by Proposition 13. This caused a much greater revenue downturn for these cities when the market values collapsed.

Proposition 13 is a state constitutional amendment approved by voters in 1978 that limits property taxes to no more than 1% of full assessed value (plus any additional rates approved by local voters, typically to support general obligation bonds). It was adopted with the intent to put limitations on the pace and level of growth of the taxable value of property in California. Under Proposition 13, with minor exceptions, a home's taxable value can only grow at 2% or less annually from the time it was last sold. In subsequent years, the home's taxable value must be the lesser of its market value and its Proposition 13 constrained value. In addition to constraining the growth of a home's taxable value, Proposition 13 also limited the property tax rate statewide to just 1% unless local voters authorized an "override" of this rate. Except to pay for general obligation bonds, voters have only rarely authorized such overrides. In contrast, in other states, tax rates can be and often are increased in times of fiscal stress when assessed value growth is flat or declining.

As a result of these features of Proposition 13, rapidly growing communities with starter homes and speculative buyers, like those of Stockton and San Bernardino, had more of their taxable values rising and falling with market values. Their property tax revenues were similarly volatile, and they were unable to compensate for the sharp loss in taxable values because raising property tax rates was not a politically acceptable option.

EXHIBIT 6

California Statewide Average FY 2010 General Revenue Sources for Cities



Source: State Controller's Office, Cities Annual Report, Nov. 11, 2011

On average, property taxes account for about 1/4 of the total revenues raised by California cities to support spending, unlike in most other states where local governments rely on property taxes for a majority of revenues. On average, the balance of revenues is derived from sales and use taxes, utility taxes and other taxes and fees. California cities get little direct state aid and in that way are less vulnerable to state spending reductions or delays than California counties and school districts, and many cities in other states.

Sales and use taxes are another significant and volatile source of California city revenue that are highly reliant on the strength of the underlying economy. The precipitous drop in home prices was accompanied by loss of employment and income. As a result, the other key revenue sources that cities

rely on also suffered declines. As the overall economy slowed driven by the housing bust, sales tax related spending dropped, as did business taxes and other fines and fees related to weak economic activity.

Generous Labor Contracts Awarded In Boom Times Have Proven Hard To Reverse

California cities have struggled with high cost labor agreements and pension benefits. Many cities granted generous wage and benefits settlements during the boom years when the costs appeared to be more affordable. However, the weak housing market, declining assessed valuations and investment losses in state (CALPERs) and local pensions funds have made these costs less affordable. For cities where the housing markets and assessed values have not recovered, the perception that voters would be highly unlikely to approve any sort of tax increase resulted in these governments balancing their budgets solely on the spending side, cutting workforce and benefits.

Fiscal Governance Practices in California Also Substantially Increase Bondholders' Risk of Distressed Exchanges and Bankruptcies

Home Rule

In recent decades, the state of California has had a strong tradition of local government "home rule", meaning that the state has not taken a strong interventionist approach to addressing the fiscal problems of local governments. Not since the state support after the passage of Proposition 13 to replace a substantial portion of local governments' lost property tax revenues has the state been willing to provide cities with additional financial aid. In fact, since the state has had its own severe fiscal challenges, in recent years it has more likely exacerbated local governments' fiscal stress by borrowing and shifting money from local governments. In some cases, dissolution of city RDA's (Redevelopment Agency) has been cited as a contributory source of fiscal stress given the loss of revenue that would have come from the RDA.

Unlike some other states, where the state either by law or by policy will intervene in the financial affairs of stressed or troubled local governments, California state policy assumes that local governments, principally cities and counties, have been given the tools and the autonomy to manage their own financial affairs.

In some states, such as New York, Michigan, Rhode Island, Pennsylvania and others, state intervention can take the form of financial assistance, technical assistance, oversight boards, or in extreme cases, state takeover by state appointed financial managers or control boards. By contrast, in California, the state's view is that it has given city and county governments the tools to address these problems by themselves. Among these tools are the ability to adopt an "emergency" resolution and the new AB 506 statute, which enables localities to file for bankruptcy after undertaking a 60-90 day "mediation" with their creditors.

We are now seeing the result of this "hands off", home rule policy in California. The combined effect of fiscal stress from the housing bust, the burden of high labor costs and benefits, and the limits of severe service reductions have caused several severely stressed municipalities to resort to using fiscal emergency powers or mediation, and then US bankruptcy courts, to renegotiate their obligations to employees and creditors.

Proposition 13

As mentioned earlier, Proposition 13 generally limits property taxes to no more than 1% of full assessed value. Market price increases are not immediately reflected in assessed values (AV), because annual increases in AV are capped at 2% or the percentage growth in the state's Consumer Price Index (CPI), whichever is less. Increasing market prices are only reflected in a home's AV when the home is sold. The AV on individual parcels can also be raised when new construction occurs, in which case the value of the new construction is added to the existing AV. Since at any given time market prices generally reflect the AV of only on a small portion of the entire stock of homes in a community, there is a significant disconnect between movements in market prices and movements in AV. The degree of connection between the two is primarily a function of the rate at which properties are changing hands.

For areas with relatively less recent development, a larger share of properties had changed hands long before the recent run-up in property values, and their AV continued to be much lower than the recent prices. The resale of such below-market assessed properties continued to result in an increase in AV, even in some cases as market prices were falling. In communities with greater concentrations of newer housing stock, the gap between market price and AV was not as wide. In fact, many homes built and purchased during the height of the run-up in home prices saw immediate declines in AV. As such properties were sold due to foreclosures and other factors, the realized market loss was immediately reflected in the AV.

While property tax revenues have historically been a stable revenue source, for cities that experienced significant AV increases during the boom period, the resultant bust has had a dramatic effect on property tax revenues. With plummeting housing prices, AV also declined rapidly due to assessor revaluations, causing revenues to decline. This revenue loss further exacerbated already stressed city finances.

AB506

A municipality in the United States is allowed to file for bankruptcy only if permitted to do so by its state. Like 28 other states, California permits many of its local government entities to file under Chapter 9 of the bankruptcy code, subject to certain restrictions. Reacting to the city of Vallejo's long and costly experience in bankruptcy, the state passed AB 506 last October, intending to prevent municipalities from rushing into bankruptcy before attempting to negotiate with creditors. Under AB 506, a city must engage in a good faith, 60-90-day confidential mediation process with its creditors. If no agreement is reached, the city can then seek bankruptcy protection.

AB 506 also permits a locality to by-pass the mediation process through a declaration of "fiscal emergency" and proceed directly to bankruptcy. San Bernardino has used this provision to accelerate its route to bankruptcy.

Originally intended as a mechanism for avoiding bankruptcy, AB 506 as amended and adopted, was designed to help speed the transition through bankruptcy if not avoid it altogether. Now, it appears that in some cases, the AB 506 process may be facilitating localities filing and qualifying for municipal bankruptcy. The law's explicit instruction to negotiate with creditors, including bondholders, appears to condone, if not normalize, less than full and timely payment to bondholders. Under federal bankruptcy law, good faith negotiation with creditors is a prerequisite for the acceptance of a bankruptcy filing. The AB 506 law suggests that offers of less than full payment to creditors is an acceptable alternative to bankruptcy and in the absence of creditor concessions, a declaration of bankruptcy is appropriate.

Accounting Irregularities

Accounting irregularities have also characterized the bankruptcy filings and the severe financial stress marking some California cities, highlighting the lack of adequate state and local oversight and internal control requirements. As these cities have struggled to maintain services and avoid tax increases, they have often turned to non-general fund sources of cash. These funds include redevelopment agencies, water and sewer enterprises, or other special revenue funds. While the use of these funds is restricted, they are often comingled for cash management purposes, and they could be borrowed by the general fund, either as long-term loans or short-term cash-flow notes.

These actions mostly masked municipalities' core revenue problems, delaying the need to make necessary cost cutting or revenue decisions and compounding the severity of their problems. Moreover, in some cases, such as Stockton and San Bernardino, the accounting for these fund actions was poorly documented and outside investigations disclosed other accounting irregularities.

Treatment Of General Obligation And Special Tax In Bankruptcy

General obligation bonds have particularly strong security features in California. There is a state constitutional requirement that voters approve separate property tax levies for GO bonds, which can only be issued for specific capital purposes. The state constitution also dictates that these property tax funds may not be used for any other purpose. These bonds are secured by separate, voter approved, unlimited debt service levies which must be sufficient to pay debt service, must be imposed by the municipality and must be used to pay debt service only.

These debt service levies are different than the Prop. 13 general fund levy that is used to fund the activities of city government and is subject to the 1% levy limit. As a general matter, cities have very low GO debt burdens and so the unlimited, voter approved GO debt service levy is usually small relative to the 1% property tax levy.

While generally untested in bankruptcy, it is our view that voter approved property tax revenues levied in California for cities, counties and school districts and pledged to general obligation bonds, would be viewed as special revenues and outside the bankruptcy estate for purposes of a Chapter 9 plan of adjustment. These property tax revenues would likely be viewed as a secured, statutory lien and therefore, likely exempt from automatic stay provisions. Since these levies are constitutionally mandated and restricted as to use, they would likely be enforceable even if a municipality sought to obtain concessions from bondholders. In California, the state constitution specifically requires these separate, unlimited, voter approved levies, however, this treatment may be different in other states given differing constitutional and structural circumstances that may not provide as strong legal protection for these bonds.

The only example of this in a California bankruptcy case involved the Sierra Kings Hospital District. In this case, the District's GO debt service levy was viewed as a "special revenue" and therefore was not subject to the automatic stay. Even in bankruptcy, these bonds continued to be paid in full and on time.

Other types of city obligations such as pension obligation bonds and lease financings are generally unsecured obligations and as such would not have the same status as GO bonds. These are generally payable from general fund appropriations, and they would therefore be vulnerable to actions taken by a city in severe financial distress. Pension obligation and lease-backed bondholders would likely be viewed as unsecured creditors in a bankruptcy and likely subject to the automatic stay as a result of the filing. Ultimately, they could be impaired as part of a plan of adjustment in the bankruptcy case.

Rating Implications

Given the deepening financial stress of many California cities, the home rule, “hands off” approach of the state as it relates to the fiscal challenges of the cities, the application of state's new laws and access to bankruptcy, we are considering the following:

» Potential across the board adjustments of debt ratings for California cities to reflect the new fiscal realities and the governmental practices in addressing them;

» Potential for downgrades for particularly economically and fiscally distressed California localities, including counties, school districts, and special districts; and,

» Potential for additional downgrades for bonds other than GOs and special tax bonds.

Expected timeline

We expect to be reviewing data for all California cities in the coming weeks and in depth reviews of stressed cities in the month of September. The results of these reviews will be communicated as they progress and any rating or outlook changes will be announced at that time.

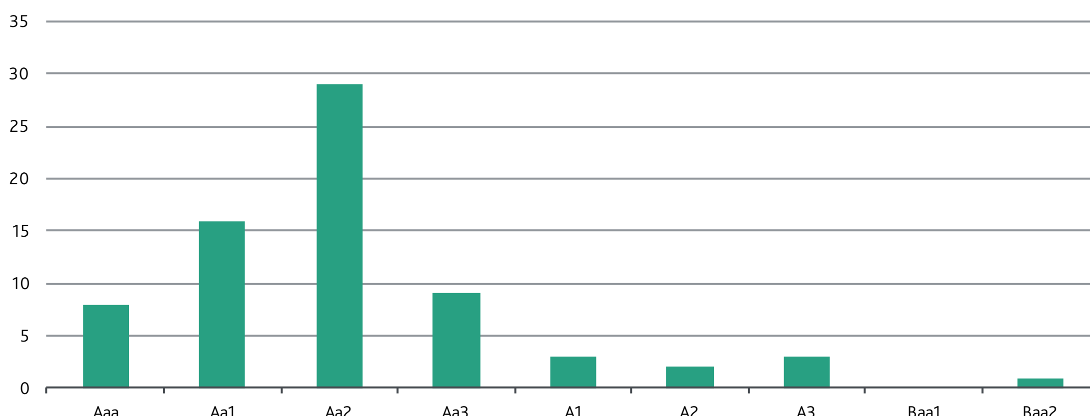
Conclusion

The fiscal risks facing California cities have a variety of causes, resulting in increased risk that bondholders could become embroiled in the solution to local government fiscal stress. We will be reviewing the overall rating distribution of California cities as well as the ratings of highly fiscally stressed cities in the near future, given the that the Aa2 average general obligation rating for California cities and the Aa3 average lease rating may not be consistent with the rising but still small risk of bankruptcy among cities. The emergence of bankruptcy as a tool to extract bondholder concession as part of a budgetary solution has now become a feature of the credit profile of stressed California cities.

Appendix – Moody's current ratings on California local governments

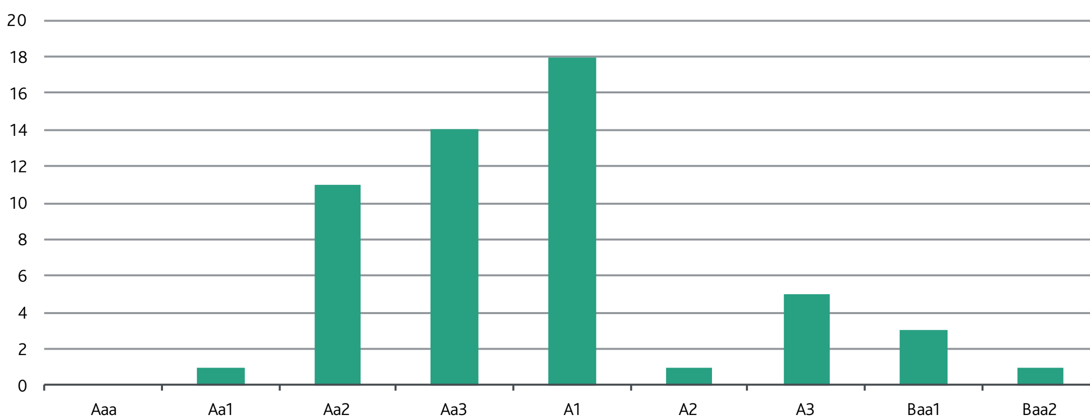
There are 482 cities in the state of California. We rate the debt of about 20% of these cities, with an average general obligation ("GO" or Issuer) rating of Aa2 and a rating range of Aaa to Baa2, and an average lease debt rating of Aa3 and a rating range of Aa1to Baa2 (or Caa3 including Stockton's rated leases). Of the three cities that have filed for bankruptcy in recent months, only Stockton has Moody's rated debt. Mammoth Lakes and San Bernardino do not have Moody's rated debt. None of these cities has general obligation bonds outstanding, rated or unrated.

EXHIBIT 7
California Cities General Obligation and Issuer Rating Distribution



Source: Moody's Investors Service

EXHIBIT 8
California Cities Lease and Pension Obligation Bond (Unsecured) Rating Distribution*



Source: Moody's Investors Service
* Stockton would appear on the unsecured chart (if the scale went to Caa1), but not on the first, since it no longer has an issuer rating

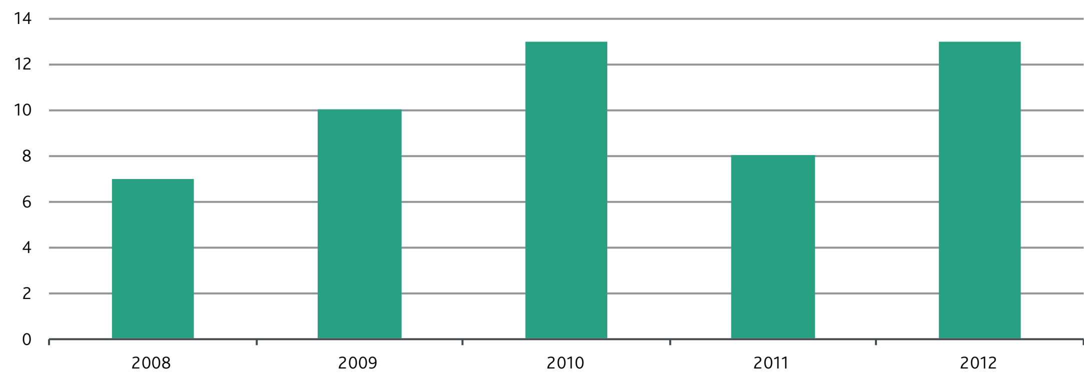
A total of 71 California cities are presented in Exhibit 7 above of general obligation ratings and issuer ratings. A total of 85 cities are presented in Exhibit 8, which shows the issuer's highest Moody's rating if an issuer has multiple, Moody's-rated unsecured obligations outstanding.

Fiscal Emergencies in California

Over the last 10 years, at least 55 of 482 California cities and 1 of 58 California counties have declared fiscal emergencies. Most have occurred in the last 5 years (53 of 56). See table below.

EXHIBIT 9

Cities in CA that declared Fiscal Emergency



Source: Various Public Reference Sources

Why Municipalities Have Declared Fiscal Emergency

The two most common purposes are:

» To put a tax increase on the ballot in an off election year (27 of 53); and

» To impose cuts on labor without meeting and conferring (24 of 53).

One of the 53 municipalities that have declared fiscal emergencies in the last five years (San Bernardino) did so to comply with the provisions of AB 506.

Key Legal Provisions Relating to Fiscal Emergencies:

Article 13 C of the California constitution Section (2)(b):

"No local government may impose, extend, or increase any general tax unless and until that tax is submitted to the electorate and approved by a majority vote. … The election required by this subdivision shall be consolidated with a regularly scheduled general election for members of the governing body of the local government, except in cases of emergency declared by a unanimous vote of the governing body."

California Government Code, Section 3516.5:

"Except in cases of emergency as provided in this section, the employer shall give reasonable written notice to each recognized employee organization affected by any law, rule, resolution, or regulation directly relating to matters within the scope of representation proposed to be adopted by the employer, and shall give such recognized employee organizations the opportunity to meet and confer with the administrative officials or their delegated representatives as may be properly designated by law."

Many California city charters also have provisions using the "Except in cases of emergency" language, effectively requiring a declaration of emergency to engage in certain actions, often the accessing of reserve funds.

Neither the state's constitution nor state statutes define "fiscal emergency" with respect to the conditions that must exist for a municipality to exercise these powers. For example, AB 506 does not define what constitutes a fiscal emergency, only that one is required prior to filing for bankruptcy. However, in order to meet the federal definition of eligibility to file for bankruptcy a city needs to demonstrate insolvency from a cash flow perspective.

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