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# Inter-American Investment Corporation

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# Inter-American Investment Corporation

## Major Rating Factors

### Strengths:

- A strong capital position and ample liquidity, supported by a recent capital increase and prudent operational practices in areas including investment and risk management.
- An important policy purpose: to support the growth and development of small and midsize enterprises in Latin American and Caribbean member countries.
- Membership in and support from the Inter-American Development Bank ('AAA'; all ratings herein are long-term issuer credit ratings).

### Weaknesses:

- A difficult mandate--especially given the small size of the institution, which limits the corporation's impact on overall economic growth and development in its Latin American and Caribbean member countries (and, consequently, its franchise value).

Counterparty Credit Rating
Foreign Currency AA-/Positive/A-1+

## Rationale

Inter-American Investment Corp. (IIC) began operations in 1989 with a mandate to finance the establishment, expansion, and modernization of small and medium-sized enterprises (SMEs). It does this by providing equity financing and short-, medium-, and long-term loans without government guarantees; by mobilizing funding from other investors; and by providing a variety of financial and technical advisory services. As of year-end 2008, IIC had 43 member countries, including all of the Inter-American Development Bank's (IADB) Latin American and Caribbean member countries (LACMCs). In January 2009, China became the 44th member of IIC.

IIC is the world's second-smallest (by assets and shareholders' equity) rated multilateral development finance institution (MDFI). The corporation's shareholders' equity was US\$744 million at year-end 2008, and its total assets were US\$1.51 billion, of which US\$904 million were loans and US\$30 million were equity investments.

The corporation's operations and financial performance have improved markedly since 2002. IIC recognized that the operational model it had employed in the 1990s was inefficient and was resulting in poor profitability, asset quality, and capitalization ratios; therefore, the corporation implemented significant changes in the early 2000s. These changes--which included new management, revisions of financial and operational policies and risk-management practices, and additional capital received from members between 2000 and 2008--have put IIC on much stronger footing. IIC also shifted more staff and decision-making independence to the local offices, increasing the efficiency and speed of operations. The qualitative improvements in IIC's business and operational models have resulted in a significantly better financial performance for the corporation in the past few years.

With its conservative risk-management strategy, IIC is well-positioned to face the current economic crisis in terms of loan portfolio quality, provisioning, its liquidity profile, and available funding. Impaired loans constituted 0.1% of total loans in 2008--the same as in 2007 and down from 17% in 2002--while loan loss allowances accounted for

almost 400% of nonaccrual loans at year-end 2008. The quality of the loan portfolio deteriorated somewhat in the first half of 2009, with impaired loans increasing to 2.8% of total loans and loan loss allowances declining to 152% of nonaccrual loans as of June 2009. However, two past-due loans, which were responsible for this increase, are currently being restructured. IIC's ratio of provisions for losses plus shareholders' equity (its narrow risk-bearing capacity) to development-related exposure (comprising loans, equity investments, and guarantees) was 85% at year-end 2008, down slightly from 91% in 2007 and among the highest for rated MDFIs.

IIC has prudently prepared itself to face the difficult external conditions. The corporation nearly doubled its cash and trading investments in 2008 to more than US\$420 million, and it has more than US\$600 million of undrawn balances in various credit facilities. This compares with US\$733 million in outstanding borrowings, of which US\$30 million is due in 2009. The amortization profile for the next four years is smooth.

In addition, IIC entered the global crisis with a strengthened capital base. This resulted from a 1999 decision by the corporation's members to increase IIC's capital from US\$203.7 million to US\$703.7 million in 2007 (followed by a further increase to US\$704.8 million in 2008). With more than 93% of the approved capital increase paid by December 2008, IIC's capital base has strengthened significantly. The U.S. (with an outstanding contribution of US\$46.1 million due) and Costa Rica (which applied for an additional 110 shares in 2008 that amounted to \$1.1 million) should increase capital further by the extended deadline of Dec. 31, 2010. New member China already paid in for 110 new shares.

In 2008, IIC's net income fell to US\$14 million from its extraordinary peak of US\$84 million in 2007. However, its 2008 return on average shareholders' equity of 1.9%--although low compared with 7.5% in 2007 (when a large gain on an equity sale improved results)--was better than the average of negative 0.6% for 2002-2006. We note that many factors that weakened IIC's profitability in 2008 were cyclical in nature (i.e., the lower-interest-rate environment and higher loss provisions), and we expect that these factors will turn around going forward.

Although IIC has made significant strides in improving its financial profile, it continues to face a difficult mandate: maintaining the value of shareholders' capital while maximizing the developmental impact of its operations. Despite the US\$500 million capital increase, IIC continues to suffer from diseconomies of scale and to face challenges regarding its ability to provide a developmental impact as effective as those of larger institutions. Recognizing this intrinsic challenge, IIC's directors have made a number of important strategic and operational changes that have positioned the corporation to achieve this difficult balance. As such, IIC has introduced a new strategic framework: the portfolio approach. With this approach, the corporation tries to look at its operations in a broader, portfolio-focused perspective, where each individual project contributes according to its own strengths and characteristics--namely development impact and financial contribution. On the operational side, IIC has also relaxed some of the strictures under which it formerly operated. It now allows lending to larger companies; it has increased lending to financial institutions; and it provides shorter-term lending in challenging markets. At the same time, the corporation has strengthened its risk-management policies.

## Outlook

The positive outlook reflects IIC's strengthened financial profile, as well as the strategic and operational initiatives the corporation put in place to preserve its sound financial performance over the past few years while maximizing the developmental impact of its operations. Although market conditions took a toll on the corporation's profitability

in 2008, its prudent risk-management approach and proactive asset/liability management minimized the impact of the global crisis on its financial profile--a drastic difference from IIC's experience during the previous crisis of 1998-2001. Further, although the corporation's small size and difficult mandate continue to be inherent credit constraints, IIC's improved financial fundamentals, more resilient policies, and new, more balanced, strategic framework should enhance its ability to meet its operational goals. The ongoing support for IIC's mandate from the board and the corporation's members should help IIC navigate the challenging market environment.

If IIC can come out of the current crisis with preserved asset quality and contained leverage, its creditworthiness will improve. In addition, the receipt of an outstanding capital contribution from the U.S. should further improve IIC's credit profile. However, if the economic meltdown is more severe than we expect, impairing the corporation's asset quality and capital base, we would consider a downward revision in the outlook. Similarly, if IIC diverts from its currently conservative leverage policies--which would result in a deterioration of its capitalization ratios--we would likewise consider an unfavorable outlook revision.

## **Membership And Voting Powers: 44 Members, With The Recent Addition of China**

IIC came into formal existence in 1986, and at year-end 1988, it had 34 member countries. Membership grew to 43 by year-end 2005, by which time all 26 of the IADB's LACMCs and all but four of its 21 nonregional members had joined. The countries that did not join IIC included Canada, the U.K., and the Republics of Croatia and Slovenia. In January 2009, China became the 44th member of the corporation by acquiring (and fully paying in) 110 shares in the IIC, or 0.16% of IIC subscribed capital. China has also contributed US\$75 million to set up a special equity fund administered by IIC to invest in small and midsize businesses and financial institutions in Latin America and the Caribbean.

LACMCs had subscribed to 52.6% of total subscribed shares as of year-end 2008; the U.S. ('AAA'), 25.0%; and the 16 nonregional countries, 22.4%. Each member has one vote for each fully paid share it holds. Although decisions are usually made by a majority of the votes cast, qualified majorities are required for some decisions. For example, at least 75% of the votes, including those of two-thirds of the governors, is necessary to authorize a major capital increase, and 80% is required to amend the agreement--also including two-thirds of the governors.

## **Governance And Organization: A Focus On Staff Utilization Efficiency**

Under the agreement upon the establishment of IIC, each country appoints a governor to IIC's board of governors; these are typically the governors of the IADB. In practice, the chairman of the IADB's board of governors also serves as the chairman of IIC's board of governors. The board of governors delegates all but a list of certain specified powers to IIC's board of executive directors. IIC's 13 executive directors are typically appointed or elected from among the IADB's executive directors or alternates, although this need not be the case. The U.S. appoints one executive director (by virtue of its being the largest single shareholder); the governors from the LACMCs elect nine executive directors; and governors from the nonregional member countries elect three executive directors.

The IADB's president is ex officio chairman of the board of executive directors, and the board of executive directors appoints a general manager to serve as chief executive officer. The current general manager, Jacques Rogozinski,

took office in January 2000, and he was confirmed for a second five-year term in January 2005. In July 2009, his contract was extended for a third term through December 2012.

IIC's staff has always been small, having peaked at about 115 in the early 1990s. At year-end 2008, IIC had an authorized staff of 107. Of those staff members, 24 were located in 11 countries in the region--Argentina, Chile, Colombia, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Paraguay, Peru, and Uruguay. (In comparison, at the beginning of 2003, IIC was present in only three countries.) The remaining staff is located at the head office in Washington, D.C. The corporation has 16 investment officers who work directly on originating and developing new projects and 11 full-time people who are assigned to supervise a portfolio of 203 corporate and financial institution projects. We expect only modest additional increases in staffing during the next several years (most being in the area of surveillance) because management intends to effectively leverage its staff.

IIC's relationship with the IADB extends well beyond the above-noted links. For instance, IIC obtains some administrative and overhead services from the IADB, including the sharing of facilities for its overseas staff, and it receives a large committed credit facility from the IADB. It also coordinates with the IADB the development of the private-sector segments of LACMC strategies and programming. We project that there will be more integration, cooperation, and cross-benefits between IIC and the IADB because of the establishment of the Vice Presidency for Private Sector and Non-Sovereign-Guaranteed Operations within the recently realigned IADB. Finally, the IADB's president has, on occasion, intervened with member governments to ensure IIC's preferred-creditor treatment.

## Balance Sheet: Second-Smallest Among Rated Multilateral Development Banks

IIC's financial statements are prepared under U.S. generally accepted accounting principles and are audited by the McLean, Va., office of Ernst & Young. Table 1 summarizes IIC's balance sheet. The most notable features include:

- Its small size, despite double-digit asset growth in the past five years. At year-end 2008, total assets equaled US\$1.5 billion, and shareholders' equity was US\$744 million--making IIC the second-smallest of the rated MDFIs by assets and shareholder's equity (behind the Caribbean Development Bank).
- The high (albeit slowing) growth of its loans (loan growth has averaged 25% annually in the past five years and 28% annually over the past three years).
- The rapid (but likewise slowing) growth in its paid-in capital, which grew by an average of 11% per year in the preceding five years.
- The rapid growth in its liabilities, which increased to US\$763 million at year-end 2008 (more than double the level at year-end 2006).
- The significant positive turnaround in retained earnings, which totaled US\$104 million at year-end 2008 (compared with US\$8 million in 2006 and in contrast to deficits in the preceding five years).

**Table 1**

<b>IIC's Balance Sheet</b>						
	<b>-- As of Dec. 31--</b>					
<b>(Mil. US\$)</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>Assets</b>						
Cash and cash equivalents	111.3	70.0	69.5	49.4	63.5	19.1
Investment securities	488.7	340.3	190.8	158.4	46.3	65.8

**Table 1**

<b>IIC's Balance Sheet (cont.)</b>						
Loan investments	904.2	796.9	619.4	432.3	342.0	306.3
Allowance for loan losses	(55.1)	(39.5)	(39.9)	(47.7)	(45.5)	(45.3)
Equity investments	29.7	43.0	67.4	69.0	100.9	112.4
Allowance for losses on equity investments	0.0	0.0	0.0	0.0	(30.7)	(41.2)
Mortgage-backed securities	0.0	0.0	0.0	0.0	0.0	0.0
Receivables and other assets	28.3	33.4	32.8	14.7	10.9	9.0
<b>Total assets</b>	<b>1507.0</b>	<b>1244.2</b>	<b>939.9</b>	<b>676.0</b>	<b>487.4</b>	<b>426.2</b>
<b>Liabilities</b>						
Accounts payable and other liabilities	29.0	10.7	10.7	11.0	8.9	6.7
Borrowings	733.8	499.0	342.2	195.7	80.0	80.0
<b>Total liabilities</b>	<b>762.8</b>	<b>509.7</b>	<b>353.0</b>	<b>206.7</b>	<b>88.9</b>	<b>86.7</b>
<b>Capital</b>						
Paid-in capital	657.6	636.5	568.1	500.9	443.9	388.4
Retained earnings/(accumulated deficit)	104.1	90.2	7.8	(31.6)	(45.3)	(48.9)
Accumulated other comprehensive income	(17.4)	7.8	11.0	0.0	0.0	0.0
<b>Total shareholders' equity</b>	<b>744.2</b>	<b>734.5</b>	<b>586.9</b>	<b>469.3</b>	<b>398.5</b>	<b>339.5</b>
<b>Memo items:</b>						
Maximum amount payable under guarantees	7.0	10.6	4.4	0.7	5.2	0.0
Undisbursed loans and equity investments	94.2	82.2	37.7	65.5	81.0	128.5

## Lending: The Rapid Growth In Development-Related Exposure In The Past Four Years Is Subsiding

Loans and equity investments totaled 62% of total assets at year-end 2008, down from 68% a year earlier. Development-related exposure (DRE) growth was in the double digits in each of the past four years, although it slowed to 11% in 2008 from 22% in 2007. The rapid growth in DRE was made possible by the increase in the corporation's capital, as well as the improvement in its operational efficiency, which stemmed from revamped lending and approval procedures, new products, and more productive staff utilization. In 2009, given the challenging economic outlook, IIC assumed a conservative stance toward DRE growth, focusing more on asset-quality preservation rather than business expansion. As evidence of this, loans declined 7% in the first half of the year, mostly due to increased repayments. We expect that loan growth will be flat in 2009, based on the anticipation of some pickup in loans (as reflected in the existing project pipeline) in the second half of this year. Additional volume (on the equity investment side) should come from the management of funds from the US\$75 million endowment offered by China.

Many IIC borrowers are domiciled in what can be considered difficult economic environments. At year-end 2008, only four of 22 countries where IIC had loans and equity outstanding were rated investment-grade by Standard & Poor's Ratings Services. On a positive note, however, IIC's loans and equity are increasingly associated with entities domiciled in these investment-grade-rated countries--amounting to 36% at year-end 2008 (up from 19% in 2007).

Compounding the effects of the difficult economic environments in which most of IIC's private-sector clients operate

is the corporation's mandate to give preferential support to SMEs. At the same time, IIC has to balance this operational goal with the financial goal established by its shareholders. To achieve this challenging equilibrium, the organization has introduced a new strategic framework, the "portfolio approach." This approach looks at IIC's operations in a broader, portfolio-focused perspective, assessing each project based on its development impact and financial contribution. Typically, large projects would provide more of a financial contribution, improving IIC's credit risk profile; and smaller, riskier ones would be high in development contribution, compensating for the higher expense per dollar invested. To help with this task, in 2008, the corporation deployed a development additionality and scoring system as a new tool to measure development effectiveness. On the operational side, IIC has relaxed some of the strictures under which it had formerly operated. It now permits lending to larger companies, has increased lending through financial institutions (operating in effect as a "second-floor" bank), and provides shorter-term lending in challenging markets.

IIC puts its focus on SMEs by using three criteria to measure size: assets, sales, and employees. Enterprises are classified in the smallest category for which two of the size criteria are satisfied. IIC's size standards are shown in table 2.

**Table 2**

<b>IIC's Client Size Criteria</b>			
<b>Enterprise</b>	<b>Assets (Mil. US\$)</b>	<b>Sales (Mil. US\$)</b>	<b>Employees</b>
Small	Less than 10	Less than 10	Fewer than 250
Medium	10-35	10-35	250-750
Large	More than 35	More than 35	More than 750

In addition to targeting private-sector enterprises, IIC's agreement also provides that "enterprises with partial share participation by government or other public entities, whose activities strengthen the private sector of the economy, are eligible for financing by the corporation."

### Lending by industry

IIC has a wide scope for its financing, consistent with its focus on SMEs. Table 3 shows IIC's lending by industrial sector. IIC's lending at year-end 2008 was directed mainly to the financial services sector, at 73% (similar to the level of the past three years, but exhibiting a significant change from 44% in 2004). This reflects the corporation's increasing practice of providing financing to smaller borrowers through local financial institutions, which enables IIC to reach its smallest borrowers more efficiently. It also enhances the quality of the corporation's loan portfolio, because IIC takes on the credit risk of the financial institution under this arrangement.

**Table 3**

<b>IIC's Loans By Sector (% of Total)</b>						
	<b>-- As of Dec. 31--</b>					
	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
Financial services	73.3	75.2	71.6	56.7	44.1	42.8
Agriculture and agribusiness	6.4	6.7	7.7	11.0	9.8	11.1
Aquaculture and fisheries	2.7	2.0	3.5	4.7	6.9	6.7
Utilities and infrastructure	3.2	3.1	2.9	4.0	4.8	6.5
Education	0.9	1.3	2.0	3.2	4.5	3.4
Chemicals and plastics	1.3	1.4	3.1	2.9	1.8	2.8

**Table 3**

<b>IIC's Loans By Sector (% of Total) (cont.)</b>						
Wood, pulp, and paper	1.4	1.0	1.8	2.9	4.3	3.8
Livestock and poultry	0.8	0.9	1.4	2.6	2.3	0.0
General manufacturing	2.6	1.5	0.8	2.4	4.5	4.0
Food, bottling, and beverages	2.1	2.3	1.2	2.2	3.0	2.2
Industrial processing zones	0.4	0.6	1.0	1.8	2.7	2.0
Tourism and hotels	0.4	0.4	0.9	1.7	2.6	4.1
Textiles, apparel, and leather	2.6	2.7	0.5	1.0	1.8	1.0
Transportation and warehousing	0.4	0.5	0.7	0.9	4.1	4.9
Other	1.4	0.3	0.8	1.9	2.8	4.8
Total	100.0	100.0	100.0	100.0	100.0	100.0

### Loan pricing

IIC's loan pricing is generally 100 bps to 600 bps over one-, three-, or six-month LIBOR. Spreads are based on the cost of recent sovereign syndicated loans to the borrower's country of domicile (or to a similarly rated country if no loan to that country has been made recently) plus an additional spread to compensate for the individual borrower's risk and the illiquidity of the loan.

### Loan maturities

Historically, IIC has concentrated on medium- and long-term lending, with maturities typically falling in the five-to-eight-year range, with a maximum of 15 years. In 2003, IIC began making short-term loans, with maturities of one to two years, for working capital and export finance purposes. Such loans meet a pressing need for many of IIC's SME clients and tend to improve the quality of its loan portfolio. At year-end 2008, 21% of IIC's outstanding loans were due in one year or less, and 74% were due after one year to five years.

### Equity investments

Table 4 shows IIC's equity investments by industrial sector. IIC's founders had been hopeful that equity investments would constitute a major portion of the corporation's assets--in the form of either direct investments or holdings in equity funds targeted at LACMCs. However, IIC's equity investments have been smaller than expected, and in recent years have fallen not only relative to loans, but also in absolute terms. In fact, gross equity investments constituted less than 2% of total assets at year-end 2008, and the trend since 2002 has been one of continuous decline. (In 2002, these investments represented as much as 30% of assets.) IIC has moved away from direct investments, and has increasingly focused its limited equity investments on funds. As is shown in table 4, investment funds represented 82% of equity investments at year-end 2008, and regional equity funds represented 60%.

IIC's 2008-2010 business plan envisages an increase in equity investment activities, due to the high developmental value of such financial participation. This time, however, IIC plans to be more actively involved in equity investment decisions, use different financial instruments, and invest in the sectors where it has direct expertise. We expect that China's endowment will foster IIC's reentry into the equity and quasi-equity market on the aforementioned new terms.

**Table 4**

<b>IIC's Equity Investments By Sector (% of Total)</b>						
<b>-- As of Dec. 31--</b>						
	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
Investment funds	82.4	71.1	67.7	71.2	75.2	77.1
Financial services	17.6	28.9	32.3	28.8	22.8	20.7
Agriculture and agribusiness	0.0	0.0	0.0	0.0	2.0	1.8
Acquaculture and fisheries	0.0	0.0	0.0	0.0	0.0	0.4
Food, bottling, and beverages	0.0	0.0	0.0	0.0	0.0	0.0
Manufacturing	0.0	0.0	0.0	0.0	0.0	0.0
Mining and oil	0.0	0.0	0.0	0.0	0.0	0.0
Livestock and poultry	0.0	0.0	0.0	0.0	0.0	0.0
Total	100.0	100.0	100.0	100.0	100.0	100.0
Memo item:						
Regional equity funds	59.7	66.1	61.7	62.1	59.7	64.9

### Total loan and equity limits

IIC does not have specific limits on its total loans. However, the sum of disbursed and committed-but-undisbursed loans and guarantees, equity investments, and LACMC mortgaged-backed securities is limited to 400% of IIC's shareholders' equity. At year-end 2008, this percentage was 139% (up from 127% in 2007), implying that, in principle, the corporation has huge leeway to increase its DRE plus committed-but-undisbursed exposure.

The corporation's current sublimit for equity and quasi-equity investments as a percentage of shareholders' equity is 40%. Disbursed equity and quasi-equity investments totaled US\$30 million at year-end 2008, versus shareholders' equity of more than US\$744 million--implying that there is ample room for more equity investments.

### Investment concentration

IIC's policies limiting concentration in its loan and equity investment portfolios include:

- **Country concentration:** the higher of either 15% of the net active approved portfolio of loans and equity (\$176 million at year-end 2008) or 15% of equity (\$112 million). IIC's largest country exposure at year-end 2008 was \$147 million in Brazil--representing 20% of shareholders' equity--followed by \$126.4 million in Peru. The country exposure has changed significantly in the past five years, as seen in table 5. For example, in 2001, IIC's exposure in Argentina constituted 15% of the total--the largest of its country exposure--but this diminished to 5% in 2008. The relatively small size of IIC's loan portfolio means that the country composition of loans can change very quickly. One of the corporation's core objectives is to further diversify its loan portfolio.
- **Sector concentration:** the greater of 10% of the total net active approved portfolio or 10% of shareholders' equity (except for financial institutions, for which the limit was 75% as of January 2008).
- **Company concentration:** IIC's financing of any one project is subject to two different types of constraints. First, IIC will generally finance no more than 33% of any single project's investment cost for new enterprises. Second, total financing per company can be no more than the higher of 5% of IIC's total loan portfolio or 5% of equity.
- **Equity investment concentration:** IIC's share of the total paid-in capital in any company is limited to 33%. The sum of equity and quasi-equity investments in any company is limited to 2%, and total exposure is limited to 5%, of IIC's equity.

Table 5

<b>IIC's Loan And Equity Concentration</b>										
<b>--As of Dec. 31--</b>										
	<b>2008</b>		<b>2007</b>		<b>2006</b>		<b>2005</b>		<b>2004</b>	
	<b>Mil. US\$</b>	<b>Total (%)</b>	<b>Mil. US\$</b>	<b>Total (%)</b>	<b>Mil. US\$</b>	<b>Total (%)</b>	<b>Mil. US\$</b>	<b>Total (%)</b>	<b>Mil. US\$</b>	<b>Total (%)</b>
Regional	54.6	5.8	61.7	7.3	77.8	11.3	73.8	14.4	82.7	18.7
Colombia	115.8	12.4	145.7	17.3	121.3	17.7	91.9	18.0	19.5	4.4
Brazil	147.0	15.7	144.8	17.2	110.2	16.1	85.0	16.7	63.9	14.4
Chile	115.8	12.4	94.7	11.3	78.0	11.4	44.1	8.6	43.9	9.9
Mexico	74.9	8.0	62.3	7.4	68.6	10.0	29.2	5.7	33.9	7.7
Argentina	46.3	5.0	32.3	3.8	14.0	2.0	20.6	4.0	27.4	6.2
Peru	126.4	13.5	116.1	13.8	68.3	10.0	20.5	4.0	27.1	6.1
Uruguay	10.1	1.1	14.9	1.8	15.0	2.2	20.4	4.0	13.8	3.1
Costa Rica	30.8	3.3	32.0	3.8	16.1	2.3	17.7	3.5	21.2	4.8
Nicaragua	32.4	3.5	34.5	4.1	14.3	2.1	17.3	3.4	10.4	2.3
Honduras	8.5	0.9	11.3	1.4	10.3	1.5	12.3	2.4	15.5	3.5
Venezuela	0.0	0.0	0.0	0.0	6.0	0.9	11.6	2.3	14.8	3.3
El Salvador	19.2	2.1	21.2	2.5	24.0	3.5	11.0	2.1	9.9	2.2
Bolivia	10.6	1.1	2.5	0.3	4.3	0.6	9.3	1.8	8.5	1.9
Panama	36.3	3.9	2.1	0.3	3.2	0.5	6.6	1.3	17.1	3.9
Paraguay	26.1	2.8	12.4	1.5	10.5	1.5	4.9	1.0	4.9	1.1
Jamaica	4.2	0.5	1.4	0.2	2.0	0.3	2.5	0.5	3.5	0.8
Trinidad & Tobago	0.6	0.1	0.6	0.1	0.6	0.1	0.8	0.1	1.6	0.4
Guyana	2.1	0.2	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Guatemala	10.0	1.1	0.0	0.0	0.0	0.0	0.5	0.0	4.2	1.0
Belize	5.6	0.6	1.5	0.2	0.0	0.0	0.0	0.0	1.0	0.2
Dominican Republic	3.1	0.3	4.6	0.5	5.0	0.7	0.0	0.0	0.0	0.0
Bahamas	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Ecuador	49.3	5.3	39.0	4.6	37.0	5.4	25.4	5.0	18.1	4.1
Suriname	4.0	0.4	4.0	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Balance sheet total	933.9	100.0	839.9	100.0	686.8	100.0	510.7	100.0	442.9	100.0
<b>Country exposure concentration</b>										
Two largest exposures	273.5	29.3	290.5	34.6	231.5	33.7	177.0	34.7	107.8	24.3
Three largest exposures	389.3	41.7	406.7	48.4	309.5	45.1	221.0	43.3	141.7	32.0
Four largest exposures	505.0	54.1	501.3	59.7	378.2	55.1	250.2	49.0	169.1	38.2
Five largest exposures	579.9	62.1	563.7	67.1	446.5	65.0	275.6	54.0	196.2	44.3

Except for its exposure to financial institutions (where guidelines were breached slightly in 2007), IIC has operated well within its guidelines in recent years.

## Risk: Focus On Preservation Of Asset Quality Amid The Global Crisis

### Development-related exposure risk and asset quality

IIC's policies call for it to classify a loan as nonaccrual when payments are 90 days past due. In practice, however, the classification is often earlier. Disbursements of loans will ordinarily be suspended when payments of principal, interest, or fees are past due.

All of IIC's loans are to private- or quasi-public-sector entities. None carry sovereign guarantees, and recipients of these loans have predominantly been SMEs--most of which operate in economic environments that have sometimes been difficult. Due to these factors, embedded credit risk in IIC's loan portfolio is much higher than that found in other MDFIs.

Table 6 presents the index of country economic conditions. This index calculates the percentage of IIC's loans and equity investments in each member country, grouping these percentages by the ratings on the countries and applying a default rate to each of the percentages. The resultant weighted average default rate is the index. The higher the index number, the more stressful economic conditions are. The number peaked at 13.2 at year-end 2001, chiefly as a result of Argentina's default (where a big chunk of IIC's loans were at that time) but has been improving since then, reflecting the improving creditworthiness of many of IIC's borrowers' members. The index stood at 10.1 in 2004, subsequently falling to 8.4 in 2005, 6.1 in 2006, and 5.5 in 2007. In 2008, the index rose to 6.9, reflecting the deterioration in creditworthiness in Argentina, Uruguay, the Dominican Republic, and Ecuador (altogether, 12% of loan portfolio)--which was only partly counterbalanced by the improving creditworthiness in Peru, Brazil, and Panama (34% of the loan portfolio). With Ecuador having come out of default in June 2009, the index is estimated to have decreased to 6.1 as of mid-2009.

**Table 6**

IIC's Loan Portfolio Quality Indicators And Provisions						
	2008	2007	2006	2005	2004	2003
Index of country economic conditions (increase denotes less favorable conditions)	6.9	5.5	6.1	8.4	10.1	12.6
Impaired loans (mil. US\$)	1	1	9	33	33	43
As a % of outstanding loans	0.1	0.1	1.5	7.6	9.5	14.2
Nonaccrual loans (mil. US\$)	14	14	29	51	64	52
As a % of outstanding loans	1.5	1.7	4.6	11.8	18.8	16.9
Loans written off (mil. US\$)	0	6	9	4	*	3
Loan writeoffs as a % of outstanding loans at previous year-end	0.0	0.9	2.0	1.1	0.1	1.0
Recoveries of loans previously written off (mil. US\$)	1	2	3	2	7	7
Provision (release of provision ) for loan losses (mil. US\$)	14	3	(2)	4	(6)	(5)
Allowance for loan losses (mil. US\$)	55	39	40	48	45	45
As a % of impaired loans	5046.6	3948.1	427.5	145.5	139.7	104.1
As a % of nonaccrual loans	394.2	283.2	139.1	93.5	70.7	87.3
As a % of outstanding loans	6.1	5.0	6.4	11.0	13.3	14.8
Equity investments written off (mil. US\$)	0	0	0	0	20	5
Equity investment writeoffs as a % of outstanding equity investments at previous year-end	0	0	0	0.0	17.7	4.0
Provision for losses on equity investments (mil. US\$)	0	0	0	0	9	4
Allowance for losses on equity investments (mil. US\$)	0	0	0	0	31	41

**Table 6**

<b>IIC's Loan Portfolio Quality Indicators And Provisions (cont.)</b>						
As a % of outstanding equity investments	0	0	0	0	30.4	36.6
<b>Memo items:</b>						
Outstanding loans (mil. US\$)	904	797	619	432	342	306
Outstanding equity investments (mil. US\$)	30	43	67	69	101	112
Allowance for losses on loans and equity investments (mil. US\$)	55	39	40	48	76	86

\*Less than US\$0.5 million.

The index is only a proxy of the credit conditions in the respective borrowing countries. In fact, two past-due loans that emerged on IIC's books in the first half of 2009 were in sovereigns for which creditworthiness has not changed in the past year (one is an investment-grade sovereign and the other is unrated). Impaired loans are also concentrated in investment-grade sovereigns. Overall, impaired loans remained at 0.1% of outstanding loans in 2008 (the same as in 2007, and down from 17% in 2002). The allowances for loan losses relative to impaired and nonaccrual loans at year-end 2008 were the highest they had been in recent years, standing at over 5,000% and 394%, respectively. Earlier in its existence, IIC did not always provision its loans adequately and on an ongoing basis; and this resulted in volatile provisioning and net income. However, IIC's current management has revamped the procedures for determining appropriate loan loss provisions, and Standard & Poor's expects these to continue to be more stable in the future.

Historically, IIC maintained a large allowance for losses on equity investments, which varied from 27% to 61% during the period 2000-2005. However, in 2006, IIC changed its accounting for equity investments. Direct equity investments and certain other equity investments where the corporation does not have significant influence are now carried at cost less impairment, and the corporation's investments in companies in which it has significant influence are accounted for under the fair-value method. Accordingly, IIC no longer carries reserves for losses on its equity investments.

The corporation has taken various measures to strengthen its credit policies and procedures over the past few years. These include:

- A reduction in the country exposure limit to 15% from the former 20%.
- A revised risk-rating system, which affects loan pricing and drives the determination of appropriate provisions.
- An increase in the percentage of the loan portfolio that may be lent to financial institutions--which represents relatively low risk for IIC--to 75% from 30%.
- The ability to lend larger amounts to individual financial institutions, which will strengthen IIC's relationship with larger LACMC financial institutions.
- The authority to make short-term loans for working capital and export finance.
- The ability to lend more than originally contemplated to larger, less-risky borrowers.

IIC has also tightened its organizational structure by separating loan origination from loan supervision, fostering both specialization and expertise while aligning responsibility. Also, the corporation has been successful in realizing value from its problem loans, including those it has written off. In anticipation of future loan growth and adherence to conservative risk-management practices, the only area where the company anticipates staff growth is the supervision department.

Overall, IIC's loan portfolio has thus far been largely resistant to the deteriorating economic conditions in the

corporation's countries of exposure. Two past-due loans as of mid-2009 reflected problems, identified in late 2008, that were specific to the company's operations and unrelated to the global market slowdown. One loan has already been restructured, and the finalization of the second loan agreement is expected in the next few months. Overall, however, as long the main recipients of IIC's loans continue to be SMEs, portfolio quality will continue to be a fundamental concern, especially when economic conditions in countries of operation deteriorate.

### **Treasury-related risk**

The risk arising from IIC's treasury activities is generally very limited, particularly when compared with the corporation's risk-bearing capacity. IIC's policies require it to place its cash and deposits with highly rated banks. Its marketable securities are mainly sovereign, agency, bank, or corporate obligations rated 'AA-' or better and asset-backed securities rated 'AAA'. IIC did not have any investments in asset- or mortgage-backed securities as of year-end 2007 or 2008, and only 4% of its trading portfolio was invested in asset-backed securities at the end of 2006—which is in sharp contrast to some other MDFIs.

The corporation's loans have traditionally been all floating-rate. However, fixed-rate loans have recently become more prominent, growing to 28% of total loans at year-end 2008 from less than 18% three years earlier. Similarly, borrowings have traditionally been floating-rate, which minimizes the risk from interest-rate mismatches on the portion of the loan portfolio funded by borrowings. However, to date, IIC has funded most of its loans and other assets with capital. Accordingly, income from loans has reflected changes in interest rates, declining when rates drop (as in 2008, when rates fell sharply) and increasing when they rise. IIC's fixed-rate loans and the fixed-rate, held-to-maturity treasury portfolio the corporation is creating will weaken this link.

All of IIC's capital and borrowings, and virtually all of its loans and other financial assets, have traditionally been denominated in U.S. dollars. However, in December 2005, the corporation started to provide local-currency financing (financed by local-currency bonds, the proceeds of which are immediately disbursed in the same currency). By year-end 2008, it had established 12 local-currency operations in five countries, for a total of \$129.7 million. Overall, the risk of loss arising directly from exchange rate changes is minimal.

## **Capital, Risk-Bearing Capacity, And Capital Adequacy: Capitalization Is Strong, But Needs To Be Preserved**

IIC's narrow-risk-bearing capacity consists of its allowances for losses and its shareholders' equity. Since it has no callable capital, its broad-risk-bearing capital is the same as its narrow-risk-bearing capital. As shown in table 7, IIC's shareholders' equity at year-end 2008 was \$744 million, having increased from \$735 million in the prior year. The pace of the equity increase slowed in 2008 to 1.3%, compared with an average of 21% over the past five years. (The previous years' double-digit growth was a result of paid-in capital contributions and strong profitability.) With most of the capital increase paid in and profitability dampened in 2008 by the low-interest-rate environment and a proactive decision to increase provisioning, the growth of shareholders' equity has slowed. Year-end equity was depressed further by a pension fund deficit (an accumulated shortfall of US\$16 million) compared with a surplus of US\$8 million in 2007).

Table 7

<b>IIC's Capital And Capital Adequacy</b>						
<b>(Mil. US\$)</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
Authorized capital	705	704	704	704	704	704
Subscribed capital	705	704	704	701	696	696
Subscriptions receivable	(47)	(67)	(136)	(200)	(252)	(308)
Paid-in capital	658	637	568	501	444	388
Retained earnings/(accumulated deficit)	104	90	8	(32)	(45)	(49)
Accumulated other comprehensive income	(17)	8	11	0	0	0
Total shareholders' equity	744	735	587	469	399	340
Allowance for loan losses and guarantees	55	40	40	48	45	45
Allowance for equity losses	0	0	0	0	31	41
Narrow-risk-bearing capacity*	799	774	627	517	475	426
Total assets	1,507	1,244	940	676	487	426
Total development-related exposure	941	851	691	502	448	419
Shareholders' equity/total assets (%)	49	59	62.4	69.4	81.8	79.7
Narrow-risk-bearing capacity/total assets (%)	53	62	66.7	76.5	97.4	99.9
Narrow-risk-bearing capacity/total development-related exposure (%)	85	91	90.7	103.0	105.9	101.7
<b>Memo item:</b>						
Gross loans	904	797	619	432	342	306
Gross equity investments	30	43	67	69	101	112
Maximum amount of payments under guarantees	7	11	4	1	5	0
Total development-related exposure	941	851	691	502	448	419

\*Total shareholders' equity plus allowances for loan and equity losses.

Pursuant to a December 1999 agreement that authorized a US\$500 million increase in IIC's capital, subscriptions were payable beginning in 2000 and ending in October 2007. All of the nearly US\$704 million of total authorized capital was subscribed at year-end 2007, with only two members not having paid contributions in full (Argentina and the U.S). In 2008, Argentina paid in its remaining shares in full, and thus, the only member with contribution arrears was the U.S. (whose arrears amounted to US\$46.1 million). Following the U.S.' reconfirmation of its commitment to pay, the IIC extended the deadline for paying in the outstanding amount until Dec. 31, 2010. If the partial payment from U.S. is received before the end of 2010, the deadline for remitting the full remaining balance may be extended until the end of 2012. In addition, during 2008, Costa Rica had subscribed for another 110 shares worth US\$1.1 million, to be paid in by November 2011. In January 2009, the new IIC member, China, subscribed for and paid in 110 shares of the capital.

As table 7 also shows, IIC has historically maintained a strong capital position. Due to both a capital increase and improving net income, the corporation's ratio of shareholders' equity to assets had increased steadily to 82% at year-end 2004 from 58% at year-end 2000, but has been declining since then. The ratio fell to 49% in 2008, as the company substantially increased its borrowing to secure sufficient liquidity for the uncertain times ahead. We expect the capitalization ratio to return to higher levels as market conditions improve. More importantly, the ratio of narrow-risk-bearing capacity to DRE continues to be high, and stood at 85% at year-end 2008 (although this was down from the high of 106% in 2004). This ratio continues to be one of the highest among MDFIs. Preservation of high capitalization is crucial for a small and private-sector-oriented institution such as IIC, and the corporation

carefully monitors its gearing ratios.

## Net Income: Profitability Hit By The Low-Interest-Rate Environment And Rising Loss Provisions

Like other MDFIs, IIC was never intended to be a profit-maximizing institution. Indeed, in light of the difficulty of its mandate, some shareholders believed at the time of the corporation's establishment that it should seek to simply break even. However, that sentiment was not reflected in IIC's agreement.

As is true for other MDFIs, the drivers of IIC's net income are interest rates (because equity continues to fund most of IIC's interest-bearing assets), the spread between interest earned on its interest-bearing assets and its cost of borrowing (for those assets funded with borrowings), the income from its equity investments, its provisions for losses on its loan portfolio, and noninterest expenses (principally administrative).

IIC's net income has historically been volatile, and the corporation suffered large losses in 1999, 2001, and 2002 because of large provisions for losses on its loans and equity investments. However, the corporation's current management has been more willing to make provisions for problem assets in a timely manner, thus reducing volatility in net income.

IIC's profitability in both absolute and relative terms--such as return on average assets plus guarantees (ROAG) and returns on average shareholders' equity (return on equity; ROE), have steadily improved during 2003-2007. A comparison of 2008 with the previous year is difficult, not only because of a drastically different economic environment, but because of a large equity sale gain (US\$49 million) recorded in 2007. With operating income of \$14 million (versus US\$83 million in 2007), IIC was able to achieve a 1% ROAG and a 1.9% ROE in 2008--a result comparable to 2004-2005 performance.

**Table 8**

<b>IIC's Net Income</b>						
<b>(Mil. US\$, unless otherwise indicated)</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
Income from investment securities	18.8	12.4	10.0	5.3	1.1	1.3
Income from loan investments, derived from:	59.1	57.2	41.7	24.1	18.6	13.4
Interest income from loans	57.3	55.0	39.9	22.3	17.1	11.9
Other loan-related income, consisting of:	1.8	2.2	1.8	1.8	1.5	1.6
Income from commitment fees	0.1	0.2	0.2	0.4	0.3	0.3
Income from front-end fees	1.2	1.5	1.3	1.0	0.8	0.7
Other loan-related income	0.5	0.5	0.4	0.4	0.4	0.5
Release of provisions for (provisions for) loan and guarantee losses	(14.2)	(3.2)	1.6	(3.5)	6.0	4.9
Total loan income	44.9	54.0	43.3	20.6	24.6	18.3
Income from mortgage-backed securities	0.0	0.0	0.0	0.0	0.0	(0.3)
Income from equity investments, derived from:	2.5	56.0	15.8	5.8	4.2	2.6
Gain from sale of equity investments	3.4	48.7	8.2	0.4	1.6	0.9
Change in the carrying value of equity investments	(1.3)	5.2	5.6	3.4	0.0	0.0
Dividends, distributions, and other equity investment income:	0.4	2.2	2.1	2.0	2.7	1.7
Dividends and distributions	0.1	2.0	1.4	1.9	1.7	1.7

**Table 8**

<b>IIC's Net Income (cont.)</b>						
Other equity investment income	0.3	0.1	0.6	0.2	1.0	0.0
Provision for losses on equity investments	0.0	0.0	0.0	0.0	(9.3)	(4.4)
Advisory service, cofinancing, and other income	3.0	6.1	4.4	4.3	2.5	3.0
Total income	83.4	131.8	71.9	39.6	26.4	20.0
Borrowing and long-term debt expense	(30.6)	(23.5)	(14.2)	(5.2)	(2.9)	(2.9)
Operating (administrative) expenses	(24.7)	(21.6)	(19.7)	(18.8)	(16.7)	(15.5)
Total expenses	(55.3)	(45.1)	(34.0)	(24.0)	(19.6)	(18.4)
Net income before provisions	28.1	86.7	37.9	15.6	6.8	1.7
Net income after provisions	13.9	83.5	39.5	12.1	3.5	2.2
Operating income	13.9	83.5	39.5	12.1	3.5	2.2
(Loss)/gain on nontrading derivatives instruments	0.0	0.0	(0.1)	1.7	0.0	0.0
Net income	13.9	83.5	39.4	13.7	3.5	2.2
<b>Memo items:</b>						
Operating return on average assets and guarantees (%)	1.0	7.6	4.9	2.1	0.8	0.5
Operating return on average shareholders' equity (%)	1.9	12.6	7.5	2.8	1.0	0.7

In 2008, IIC's profitability was affected by a number of factors that were cyclical in nature. However, a number of positive structural changes within the company over the past five years allowed it to minimize the impact of the volatile economic environment. We anticipate that increased lending, higher pricing, and lower provisioning in the second half of 2009 will further boost profitability this year and that IIC's results will return to higher levels in a year or two, with the corporation achieving the 3% ROE targeted by member countries as part of their 1999 capital contribution decision.

The following factors influenced IIC's 2008 profitability:

- The significant drop in interest rates led to lower interest rates on loans. This was counterbalanced by growth in the loan portfolio. On the other hand, borrowing costs increased as the company funded a large increase in liquid assets so it would be in a better position to face the uncertain market conditions.
- Smaller gains on equity sales dampened equity investment income.
- Interest income from investment securities increased to \$19 million in 2008 from \$12 million in 2007. Since investment securities balances doubled during 2008, the return was lower than that in 2007. (We note, however, that the drop in the return was due to the rebalancing of the portfolio toward government securities from corporates--a prudent move in 2008. Hence, in comparison to the results posted by many of IIC's peers'--whose investment policies were less conservative and led to losses--IIC's investment income was relatively strong.)
- Advisory and cofinancing income was halved in 2008, as the cofinancing market practically shut down. Our expectation is that IIC will use a Chinese US\$75 million fund (with the initial investment of US\$20 million in the second half of 2009), which should give somewhat of a boost to this category in 2009.

We remain cautious on IIC's 2009 profitability outlook. In recognition of the challenging credit environment, over the past six months IIC has been proactively increasing its loan prices, preparing to assume higher interest costs in the near future. On the other hand, the provision for loan and guarantee losses may be lower in 2009, which would improve IIC's net income. The loan and guarantee loss provisions amounted to US\$14.2 million in 2008--the highest level since 2002--but according to unaudited statements for the first five months of 2009, loss provisions fell to

US\$4.9 million during the period. The company anticipates reducing its loan loss provision in 2009 compared with the previous year, as both of its bad loans have been addressed.

## Borrowings And Liquidity: Liquidity, Prudently Boosted To Face The Crisis, Remains Among The Strongest Of Rated MDFIs

IIC's borrowing started to increase in 2005, and has grown by an average of 78% (albeit from a low base) in the past four years. While the debt increase between 2005 and 2007 reflected strong growth in loans, the 2008 increase was mostly due to the corporation's cautiously increasing its liquid assets portfolio in anticipation of uncertain credit conditions. The corporation's debt stood at \$734 million at year-end 2008, versus \$499 million a year earlier.

As a result of this conservative strategy, IIC's cash and marketable securities amounted to \$600 million in 2008 versus US\$410 million in 2007, a 46% increase. However, we note that although the cost of maintaining so much liquidity in times of declining interest rates may be high, it's a justifiable compromise for a small and cycle-dependent entity such as IIC.

IIC's policies require that liquidity cover 100% of undisbursed commitments. Further, cash and marketable securities must cover at least 30% of these requirements. At year-end 2008, IIC's had undisbursed commitments of \$94 million.

For the purpose of calculating its liquidity, IIC includes the undrawn balances under committed credit facilities from financial institutions rated 'AA' or higher. Not all of them are 'AA'-rated institutions, but as of June 2009, IIC had in place credit facilities from seven different commercial financial institutions and one from IADB. These facilities totaled \$607 million in mid-2009, up from US\$562 million at the end of 2008. Three of the facilities (two from commercial banks, totaling US\$100 million, and one from the IADB, totaling US\$200 million [unused]) are expiring in 2010.

Overall, IIC's liquidity position is among the strongest of rated MDFIs. This, combined with the corporation's sound treasury position, minimizes its credit risk.

IIC's amortization profile is smooth, with US\$30 million of debt maturing in 2009, US\$101.5 million due in November and December 2010 (matched to respective payments from the financed projects), US\$107 million due in 2011, and US\$162 million due in 2012.

### Ratings Detail (As Of August 4, 2009)\*

#### Inter-American Investment Corporation

Counterparty Credit Rating

*Foreign Currency* AA-/Positive/A-1+

Senior Unsecured (1 Issue) AA-

#### Counterparty Credit Ratings History

15-Jul-2008 *Foreign Currency* AA-/Positive/A-1+

17-May-2005 AA-/Stable/A-1+

22-Aug-2002 AA/Negative/A-1+

\*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.



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