

Methodology

*Rating Canadian Equipment Finance
Securitization*

JUNE 2010



Insight beyond the rating.

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Introduction

Equipment loans and leases have been a significant part of the Canadian securitization market for both asset-backed commercial paper (ABCP) issuers and term asset-backed securities (ABS) issuers. The underlying loans and leases are originated by both captive finance companies associated with a manufacturer and third-party lenders. Although smaller finance companies have periodically accessed the market in the past, the securitization market has recently focused more on larger, multinational entities for originations.

Although the financial obligations are either loans or leases, there is minimal exposure to the residual value as the obligor is usually responsible for any shortfall upon remarketing of the equipment, thereby eliminating many of the cash flow differences between these forms of financing. The financed assets range from small-ticket items such as office equipment to medium- and large-ticket items such as transportation vehicles and farm implements. Generally, the portfolios provide diversified collateral, although there may be an industry concentration for captive finance companies as the manufacturers tend to focus on a limited number of industries such as construction or agriculture. In most cases, the underlying equipment is used by the borrower to generate revenue, ensuring that payments remain current to the greatest extent possible.

While equipment securitization deals have similar credit characteristics as other amortizing pools such as auto loans and leases, they also have a number of unique features that must be considered in the analysis of the transaction. In particular, equipment securitization can encompass a wide variety of asset types that must be analyzed across transactions. The specialized nature of the equipment, some of which can be long-lived, and the remarketing channels must be considered as part of the recovery valuation. Also, certain sectors, such as agriculture, have seasonal cash flows, and contracts for these and other sectors often allow for periodic payments, which the transaction structure must account for. The following methodology details the DBRS rating approach for equipment securitizations.

DBRS Rating Methodology

DBRS credit ratings are forward-looking opinions that are intended to assess the probability of the timely payment of outstanding obligations issued to fund the purchase of assets. Should actual performance of the asset pool result in a fundamental change in the credit profile from that exhibited at the outset of the transaction, DBRS will re-assess the ratings. This may result in a downgrade, confirmation or upgrade of the rating, depending on the nature of the performance.

A key factor in the rating process is the review of the originator of the assets. DBRS reviews the financial health of the originator, with a rating usually provided by its Financial Institutions group as to the financial strength of the company. Reviews of the management structure and experience of the originator and its corporate strategy are also conducted. These reviews are undertaken to determine the company's wherewithal as a servicer and its ability to originate and underwrite assets in a consistent manner. In addition, if the originator is also the conduit sponsor, as is the case in many ABS transactions, it must meet the requirements set out in the DBRS *Criteria for New ABCP Conduit Sponsors*.



In its review of equipment pools, DBRS employs static pool analysis, focusing on delinquency, default and loss performance of the originator's historic portfolios. Generally, DBRS looks for five to ten years of historic portfolio information. The objective is to complete an analysis through an economic cycle to understand what the performance of the obligations might look like during the life of the securitization transaction. When determining expected asset pool performance, DBRS reviews multiple vintages of originations and generally assumes a worst-case scenario instead of using averages. This is intended to capture the portfolio performance volatility that can occur, reflecting the internal origination and operational changes as well as the impact of external economic forces.

Originators

Securitization has been a significant source of liquidity for the equipment finance industry, providing capital equipment to businesses in Canada. Equipment finance securitization has been active in Canada since the early 1990s, with issuance by firms such as Case Credit Ltd. (the forerunner of CNH Capital Canada Ltd.) and Newcourt Capital leading the market, followed by other captive finance and third-party finance companies. While there has been a downturn in issuance since the advent of the credit crisis in August 2007, the contraction has been experienced by all asset classes and equipment finance issuance is expected to return to more normalized levels.

A wide variety of equipment types have been securitized, ranging from small-ticket items such as photocopiers and telecommunications equipment to large-ticket items such as specialty trucks, agricultural equipment and locomotives. Over time, securitization issuance has shifted to the larger, better capitalized companies, although some smaller, third-party finance companies with long relationships with ABCP conduit administrators continue to have access to the securitization market. With this change has come a move toward assets with more remarketing channels, such as transportation vehicles, although the equipment financed generally remains directly involved in generating revenue and is considered integral to the ongoing running of the business.

The underpinning pools of assets also tend to differ based on the type of originator, either a captive finance company or a third-party financial institution. Captive finance companies have a portfolio of loans and leases that reflect both the equipment manufactured by their parent companies and the industries that use the equipment. These portfolios tend to have performance histories that reflect the financial health of the industries they serve and are more homogeneous in nature. The clients are often long-term users of that particular brand of equipment and have demonstrated brand loyalty, providing consistency in the portfolio performance.

Third-party finance companies tend to have more diversified obligor and equipment bases. Usually, they will have several niches that they service, such as a particular geographic region, small or medium-sized business operators or a specialized business line such as medical professionals. There is generally no concentration in a specific brand of equipment financed, although third-party finance companies may have concentration in certain types of equipment such as transport trucks. The overall performance is less tied to the financial health of a specific industry and reflects more the overall economic performance of the segments they serve as well as the credit underwriting policies for the overall portfolio.

In addition to a financial review conducted by DBRS's Financial Institutions group to assign a rating of the financial health of the originator, the Structured Finance group will conduct an on-site operational review, which focuses on the origination and underwriting of the loans and leases as well as on the credit adjudication and collection processes. The on-site operational review is a key element of the analysis of an originator that is both the seller and servicer of the portfolio that will be funded by the notes issued and can highlight certain performance aspects of the portfolio.



Asset origination channels effectively fall into two categories: in-house or purchased through a broker network. While both channels have their advantages, DBRS considers an in-house network to have more consistent and conservative practices than a broker network. This is in part due to the company's ability to oversee all facets of the process and in part due to the compensation framework associated with a broker. For some specialized equipment or specific geographic locations, DBRS will accept broker-originated assets on a comparable basis if the company has re-underwritten the obligations.

The underwriting practices are reviewed to ensure that correct policies and procedures are in place to provide for a consistent quality of financing over time. The practices should include documented policies and procedures for the receipt and handling of applications; review of financial materials, including credit scoring and the appropriate legal documents required to support the financing; and a security interest in the underlying equipment. Application approval should be based on predetermined authority levels commensurate with the exposure for the loan or lease.

Portfolio Servicing

On an ongoing basis, a certain number of loans and leases will have past-due payments. DBRS reviews the collection process and procedures that the originator employs for accounts that are past due. The processes should reflect the nature of the client base that they are dealing with and dovetail with the demonstrated performance history of the portfolio. Any changes in procedure will be noted, especially where performance of the portfolio has changed on a historic basis. Although not as prevalent as with consumer obligations, the use of pre-authorized payments allows for both better management of the payment stream and a reduction in early-stage delinquencies as payments are made automatically without the need for the obligor to initiate them. For industries with a more seasonal payment structure, such as agriculture, pre-authorized payments are generally not used.

The past-due collections process is especially important for reducing the default levels and, when combined with the remarketing efforts, for reducing net losses given default. The originator should have a dedicated team of collectors demonstrating experience commensurate with the severity of the defaults that they are dealing with. Often, firms will employ separate early-stage default and late-stage default teams, reflecting the differences in collection techniques required as an account ages. These efforts should be supported by a framework of management reporting to allow appropriate analysis of the portfolio and monitoring of the performance in a timely manner.

In addition to the collections process, the remarketing strategy and network is reviewed. The process will differ for each firm and will also differ between captive finance companies and third-party finance companies. This difference is driven in part by the more focused equipment line that the captive finance companies have and the existence of an affiliated dealer network that provides a ready-made first source for remarketing. Differences will also exist for those firms that extend credit on items with little recovery value, such as office equipment. In all instances, it is important to understand what the company's strategy toward remarketing is, how it fits with its late-stage collection philosophy and how the process is implemented.

An additional area of servicer review relates to ongoing cash management. The control of cash is less of a concern for investment-grade entities as DBRS policy allows for the commingling of payments with general corporate funds and monthly remittance to the trust by these entities. Under certain circumstances, including at a minimum any bankruptcy filing by the servicer, the trust must have the right to appoint a replacement servicer.



For non-investment-grade servicers, other mitigants, such as the use of lock boxes, more frequent reporting or daily remittance of cash to accounts controlled by the trust, are often used and must be taken into consideration. In addition, a backup servicer may be engaged from the outset of the transaction, which may have an impact on the transaction, depending on the role and functions of the backup servicer. The classifications range from a “cold” backup servicer, which has minimal day-to-day responsibilities, to a “hot” backup servicer, which is actively involved in monitoring and reviewing the portfolio in parallel with the regular servicer.

One final area of review is the systems architecture of the originator. This allows for an understanding of the various sources of information, linkages of reports and nature of management reporting used in the management of the receivables. It is intended as a confirmation of the sources of information and will also include an overview of the company’s information storage and disaster-recovery programs.

Types of Financing

Equipment financing comes in two basic types of obligations: loans or leases. For loans, the ownership of the equipment is transferred to the obligor, with full repayment of the principal required by an agreed-upon date, and there is no exposure to any residual value by the finance company. Leases have two forms: capital leases and operating leases. In both types of leases, the ownership of the equipment remains with the finance company, but the obligor uses the equipment for a predetermined period of time in exchange for regular payments. There are a number of accounting and legal differences between capital leases and operating leases. A key difference is that for capital leases, the lessee has the use of the vehicle for most of the economic life, with minimal residual value exposure, while an operating lease allows the lessee to return the equipment to the finance company after an agreed-upon time, at which point the finance company is exposed to the residual value risk of the equipment as it attempts to either re-lease it or sell it.

In Canadian equipment securitization transactions, most obligations are either loans or capital leases. When capital leases are securitized, the lessee is usually responsible for any residual value loss on the equipment upon remarketing and must pay the finance company for any shortfall, with no residual value exposure on leases taken in the transaction. This is similar to a loan, where the obligor is responsible for full repayment of the advance, with no consideration for any value change in the underlying equipment. In this manner, the finance company and, hence, the securitization structure are insulated from any residual value risk of the equipment. Some transactions incorporate a small number of operating leases as part of a larger portfolio; any residual value exposure must be incorporated into the risk assessment of the transaction.

As a result of the similar profile of both capital leases and loans, the cash flow analysis does not differentiate between the two unless the historic loss performance indicates a difference in the credit profile and performance of one or the other type of financing.

The structural framework supporting the transaction is vitally important to ensure that the interest in the loans and leases meets the legal requirements for being treated as bankruptcy remote from the finance company. This allows the transaction to be rated on the basis of the expected performance of the asset pool and the structure without being affected by the credit rating of the finance company itself. Legal documents are reviewed in advance of closing by DBRS and must be supported by a series of legal opinions to ensure that the transaction is both bankruptcy remote from the finance company and is considered to be a true sale of the assets. For more specific details on the legal requirements, please see the DBRS *Legal Criteria for Canadian Structured Finance*.



Eligibility Criteria

To ensure that the securitized pool is similar in nature to the analyzed portfolio, securitization transactions set out eligibility criteria in the legal documents, covering such issues as maximum term, advance rate and payment frequency for the loan or lease; obligor and equipment concentration; balloon payments; and residual value exposure for the portfolio.

At a minimum, the terms of the contracts should not exceed the useful life of the underlying equipment being financed. While many types of assets are long-lived and maintain significant value during their useful life, the terms of equipment financing for securitization purposes should not exceed seven to ten years, depending on the useful life of the type of equipment, and, in many cases, the terms will be shorter. It is expected that the entire portfolio would not be composed solely of longer-term financings as this introduces a greater period of uncertainty around factors that may affect the performance of the underlying assets. For those segments of the pool with longer maturities, an adjustment will be made to the base-case loss assumptions to incorporate the higher degree of risk. Used equipment is acceptable as collateral, but only for those asset types with longer useful lives, with levels restricted for assets that do not retain significant value over time.

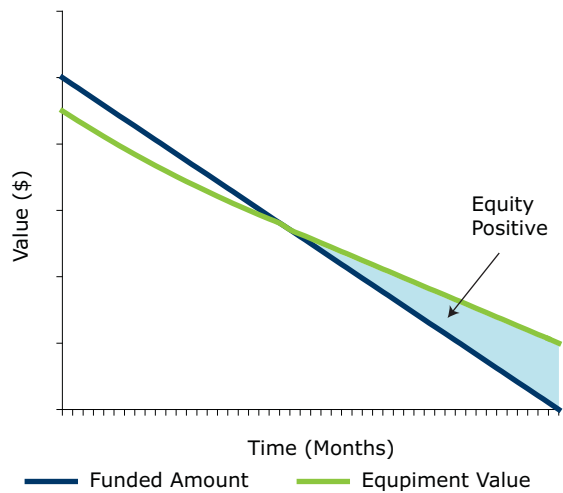
Most Canadian equipment portfolios are geographically diversified, with the larger exposures to the provinces in which the industries using the equipment operate. For example, it is usual that a portfolio will have a larger exposure to Ontario and Québec as both provinces have strong industrial and agricultural bases that are well serviced by equipment finance companies. In addition, if a finance company covers the agriculture industry, higher levels of exposure to Alberta, Saskatchewan or Manitoba would be normal. This geographic diversification is important as it usually helps temper the severity of economic downturns experienced by one region with more positive performance in another.

The financed amount of the equipment should not exceed 100% of the all-in cost, including retail purchase price, taxes and a reasonable commission as a percentage of the purchase price. There should be no monetization of future interest flows in the deal. Situations where the advance rate is greater than the initial price of the equipment are considered somewhat more risky in that they do not benefit from the same potential recovery from the equipment should it be necessary to liquidate it in a default scenario.

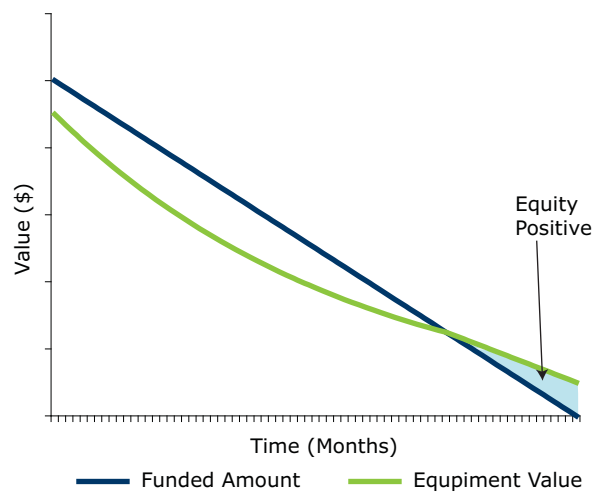
DBRS also reviews the finance company's strategy and target for the timing of the financing to achieve positive equity relative to the underlying equipment. This is the point in the term of the financing at which the equipment value, based on expected depreciation, exceeds the remaining principal balance on the financing. As can be seen from the graphs below, the sooner that positive equity is achieved, the sooner expected losses decline as the obligor has an equity interest to maintain and the equipment can be remarketed to repay the outstanding obligation. There are a number of factors that affect this timing, including the following:

- Required down payment levels.
- Term of the financing, with longer-term financings requiring longer repayment periods.
- Depreciation profile of the equipment.
- Available remarketing channels.
- Specialized or seasonal use of the equipment.

Short-Term



Long-Term



Source: DBRS.

The above graphs are intended to illustrate the different profiles of short-term and long-term financings. In short-term financing, the underlying equipment becomes equity positive (i.e., the resale value exceeds the outstanding funding) at a much earlier date than in long-term financing.

One final area of consideration is the nature of the contract between the obligor and the finance company. These contracts should be standard among the obligors for each type of financing, and material amendments to the documents should not be allowed. The contract must allow for the sale and assignment of the interests in the cash flows and ownership interest in the equipment, under appropriate circumstances and within legal requirements, to a third party such as a trust that then uses this ownership interest to support the issuance of asset-backed notes.

Portfolio Analysis

For each transaction, a historic review of the performance of pools of loans and leases of the finance company is undertaken by origination period. For each static pool, cumulative net loss curves are collected and reviewed to better understand the frequency and timing of losses. This historic information is gathered for the different types of assets funded by the originator to enable a more granular review of the expected performance of the securitized pool by looking at its asset composition. Generally, a six-month lag for recoveries is assumed when using net loss data for modeling purposes.

This information is compared with default levels as well as other market forces, such as timing and value of recoveries from sale, to determine all the factors that can lead to a loss. This static pool analysis enables DBRS to review the performance of the assets through various economic cycles and monitor the impact of changes in underwriting and collections practices.

If gross loss levels instead of net loss levels are provided, the analysis must incorporate the value of the underlying equipment and the time frame for its disposal. DBRS reviews the history of the performance before assigning appropriate stress levels to the recovery value of the assets. Ranges for both the timing and lag on asset recovery are used, depending on the desired ratings threshold. The table below summarizes the normal stresses used to determine the base-case loss scenario when employing gross loss numbers.



Credit for Recoveries

	AAA	AA	A	BBB	BB or less
Recovery credit	50%	66%	75%	80% to 85%	90% to 100%
Recovery lag (in months)	4 to 5	3 to 4	2 to 3	2	1 to 2

As a general rule, DBRS takes into consideration the most conservative results when determining the base-case loss levels to be applied to the proposed pool, which reflects DBRS's approach of rating transactions through an economic cycle. Thus, DBRS is conservative when reviewing static loss information in an attempt to capture results under various economic situations.

For each transaction, a pool cut is received that provides a thorough picture on the proposed pool of assets to be sold. This will generally include scheduled cash flows from the loan and lease payments; terms of the underlying obligations; timing of any seasonal, balloon or residual payments due from the obligor; types of assets financed (e.g., new versus used equipment); largest ten obligor exposures by name; geographic breakdown; industry breakdown; and the interest generated on the outstanding loans and leases. Since subvented interest rates are much less common in equipment financings than in the consumer-based auto finance industry, interest payments are important in the monthly cash flow of the transaction and can form part of the credit enhancement available to prevent noteholder losses in the form of excess spread.

If the interest rate generated by the pool is unusually high or low, this can be an indicator of the credit quality of the underlying obligors or type of financing and will be reviewed as part of the portfolio analysis. It is common for pools with low rates of interest to use a higher discount rate than the pool interest rate to generate yield on the portfolio. DBRS does not allow for a discount rate substantially below the yield on the portfolio to be incorporated in the transaction as this effectively monetizes future interest flows. This practice could lead to increased loss levels being experienced as it would include the monetized level of foregone future interest payments in the initial funding amounts.

The pool composition is reviewed to determine whether there are any pool characteristics that would suggest that its performance would differ from the historic static pools previously reviewed. Such factors as seasoning of the pool, industry concentrations and performance, tenor of the loan or lease, model type or new versus used composition, and recovery levels are all considered. DBRS takes into consideration the historic performance among the different types of assets financed as well as the actual pool composition during its review. From this analysis, a projected base-case loss curve is derived that analyzes the expected performance of the securitized pool over the life of the assets and provides an estimated cumulative loss level. This base case is in turn used in the quantitative model review of the level and composition of the credit enhancement.



Credit Enhancement Calculation and Composition

Credit enhancement levels are intended to protect noteholders from the loss of principal or interest throughout the life of the pool of assets that have been securitized. As described above, DBRS considers the performance history of the finance company's portfolio in conjunction with the pool being sold and any external factors that could affect performance when deriving a base-case loss curve. Therefore, the base-case loss curve may be adjusted from transaction to transaction to reflect different performance history, pool composition or other factors that are anticipated to affect the performance of the identified pool of equipment financing. Prefunding of future asset purchases will be considered on an exception basis only and then only for a limited time. If prefunded assets are included in a transaction, the structure must assume a conservative asset mix and credit enhancement levels will be increased.

The base-case loss curve is used when modeling the monthly cash flows to review the impact of different scenarios on the performance of the pool and the proposed credit enhancement levels. DBRS uses a proprietary cash flow model for this purpose and considers different scenarios provided by involved parties when determining the minimum level of credit enhancement required to support the desired rating levels.

Consistent with other traditional assets, the minimum required credit enhancement level coverage of the base-case losses varies according to the desired rating level for the associated notes (see the table below).

Base-Case Coverage Levels

Rating Level	Minimum Coverage
AAA	4.0x to 6.0x
AA	3.0x to 5.0x
A	2.5x to 3.5x
BBB	2.25x to 3.0x

The above table of coverage levels assumes that the pool of assets will have demonstrated diversification, especially as it pertains to obligor concentration levels. When considering obligor concentration levels, all obligations within the pool of an obligor and its affiliates must be captured on a combined basis, not just the exposure to any one loan or lease. This reflects the fact that obligors are likely to default on all their obligations, not just one, if they experience financial distress. Consistent with other traditional assets, the minimum credit enhancement coverage of obligor concentrations based on the desired ratings levels are shown in the table below.

Credit Enhancement Levels

Obligor Rating Level	Maximum Per Cent of Credit Enhancement
AAA	100%
AA	50%
A	33%
BBB	25%
BB or less	16%



FORMS OF CREDIT ENHANCEMENT

The credit enhancement for an equipment securitization structure is expected to be some combination of overcollateralization, cash reserves, subordinated notes and excess spread. In addition, other forms of enhancement such as letters of credit or guarantees will be considered in any proposal received, provided they are supported by an institution meeting the required ratings threshold (see the DBRS *Legal Criteria for Canadian Structured Finance*).

Typical equipment pools will be supported by overcollateralization and cash reserves. Generally, overcollateralization levels are set at the outset of a transaction at a level to cover a portion of the stressed loss levels for the desired rating. These levels will grow as a percentage of the outstanding notes because of the requirement that the overcollateralization stop amortizing at a certain floor level, usually no lower than 50% to 75% of the initial enhancement, depending on the structure. Subsequent to this, the pool will continue to amortize as loans and leases are repaid, leading to an increasing percentage of enhancement. Cash reserves generally have a high floor level, often 100% of the initial level, as they are intended to provide liquidity within the structure if it is not otherwise available. If a cash reserve reaches its floor level, subsequent draws should be replenished from excess spread prior to funds being released to the originator.

The use of subordinated notes is more common in ABS transactions than in ABCP transactions, depending on investor appetite, and is designed to provide support to the senior funding tranche. The required size of any subordinated note is set at the outset of the transaction and it does not usually amortize with the senior notes. Therefore, as the pool amortizes, the subordinated notes provide an increasing level of enhancement to the senior notes and additional protection against late-stage performance volatility.

DBRS considers excess spread as a component of credit enhancement but generally does not give credit to more than one year's excess spread unless there is a specific mechanic in the transaction to prevent the release of any excess spread on an ongoing basis. That excess spread is not given greater value is due to the number of factors that affect the levels available to protect noteholders, such as timing of losses, the release of excess spread to the originator and unforeseen prepayment levels.

Portfolio Termination Events

Termination events related to portfolio performance are linked to key variables considered in the evaluation of the asset pool and the structural aspects of the transaction at the outset of the rating analysis. Therefore, termination events should mirror the key risk elements that could affect the likelihood of repayment for the noteholders. As part of its review, DBRS considers historic portfolio performance for a period of at least five years, with a preference for a longer time series if it is available. The proposed termination events are reviewed and compared with actual historic performance to ensure that the levels would capture a substantive shift in the performance risk of the pool, while at the same time allowing the normal business fluctuations to occur.

Generally, termination events will relate to the aging of the portfolio (delinquency or default metrics) and loss performance of the portfolio. The termination event levels are to be set at a level such that sufficient enhancement remains within the structure to ensure repayment of the underlying notes. Usually, a termination event will result in the acceleration of the repayment of the notes by capturing all excess cash flow in the deal and applying it to the outstanding principal balance.



Structural Issues

All transactions must comply with the DBRS *Legal Criteria for Canadian Structured Finance*. This criteria are updated periodically to reflect developments in law and the marketplace. For example, equipment finance transactions are expected to be structured as bankruptcy remote from the finance company and the equipment manufacturer.

One key risk element that is often found in equipment finance transactions is a mismatch between the funding basis of the underlying assets and that of the notes issued by the funding trust. To the extent that a fixed-rate versus floating-rate mismatch exists, hedging arrangements will need to be entered into to remove this exposure from the trust and ensure that the noteholders have access to the appropriate type of interest flow. A similar issue exists if there is a currency mismatch between the underlying finance obligations and the currency of the notes that fund the assets. In both instances, the trust is unable to deal with this risk position, and appropriate hedging must be entered into at the inception of the transaction.

A review of the requirements for swap counterparties can be found in the DBRS *Swap Criteria for Canadian Structured Finance Transactions*.

Conclusion

Equipment finance securitizations have been an important part of the securitization market in Canada since its inception. The underlying pools have performed well and generally remained within expected performance ranges during the life of the transactions. This stable performance can be linked to a number of factors, including the importance of the underlying equipment to the livelihood of the users, the conservative approach of finance companies and the long-lived nature of the equipment itself. This methodology serves to outline the approach that DBRS employs when reviewing equipment finance securitizations, providing guidance to the key risk elements that must be dealt with, along with appropriate stress levels for the desired ratings levels.

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