GCR RATINGS

Credit Rating Report | Commercial Property | August 2024

Equites Property Fund Limited

Rated Entity / Issue	Rating class	Rating scale	Rating	Outlook / Watch
Equites Property Fund Limited	Long Term Issuer Short Term Issuer	National National	AA-(ZA) A1+(ZA)	Stable Outlook

Analytical entity

Equites Property Fund Limited (Equites or the REIT) is a JSE listed REIT with a focus on developing and owning large, modern logistics assets in central nodes. The REIT has assets in South Africa and in the United Kingdom (UK). Equites' strategic mandate is to expand its portfolio through a pipeline of developments, selective acquisitions and partnerships. Property and asset management is conducted internally.

Credit profile summary

Strengths

- Growing logistics property portfolio with moderate diversity to UK,
- High quality assets focused on ESG credentials,
- Long-dated leases to quality tenants with embedded rent uplift underpin secure and growing rentals,
- Good access to diverse sources of funding, with large pool of unencumbered assets.

Weaknesses

- Sizeable development pipeline adds pressure to funding and liquidity,
- Some tenant concentration,
- Challenging economic fundamentals in both core markets.

Rating summary

Equites' ratings reflect its strong income generation from a growing portfolio of high-quality logistics assets that is moderately diversified geographically. The REIT's current growth strategy centres solely on its sizeable South African development pipeline, with financial leverage expected to remain moderate through the ongoing application of planned sale proceeds.

Outlook statement

The Stable outlook reflects GCR's view that Equites will continue to benefit from high demand in the resilient logistics segment, supporting strong portfolio growth in South Africa and thus cash flows. Furthermore, we believe the REIT will maintain moderate leverage as it pursues its growth strategy.

Rating triggers

Upward rating progression is only likely over the medium to longer term as Equites increases the scale of its portfolio and maintains strong performance metrics, whilst at the same time achieves sustained lower leverage and strong liquidity.

GCR could lower the rating if the LTV sustains above 40% or if interest coverage falls to or below 2.1x. This could occur if it continues its growth strategy with predominately debt financing or if operating performance unexpectedly weakens. We could also lower the rating if liquidity pressure becomes severe.

Risk score summary

Rating components & factors	Risk Score
Operating environment	**14.75**
Country risk score	8.25
Sector risk score	6.50
Business profile	**1.00**
Portfolio quality	1.00
Management & governance	0.00
Financial profile	**(0.75)**
Leverage & capital structure	(0.50)
Liquidity	(0.25)
Comparative profile	**0.00**
Group support	0.00
Peer analysis	0.00
Total risk score	**15.00**

Analytical contacts

Primary analyst	Sheri Morgan	Deputy Sector Head: Corporate and Public Sector
Johannesburg, ZA	Morgan@GCRratings.com	+27 11 784 1771
Committee chair	Femi Atere	Sector Head: Corporate and Public Sector, Nigeria
Lagos, NG	femi@GCRratings.com	+27 11 784 1771

Related criteria and research

Criteria for the GCR Ratings Framework, May 2024
GCR Rating Scales Symbols and Definitions, May 2023
Criteria for Rating Real Estate Investment Trusts and Other Commercial Property Companies, May 2024
GCR Country Risk Score report, July 2024
GCR SA Corporate Sector Risk Score report, March 2024
GCR Commercial Property Sector Risk Score report, July 2024

Ratings history

Equites Property Fund Limited					
Rating class	Review	Rating scale	Rating	Outlook/Watch	Date
Long Term Issuer	Initial	National	A(ZA)	Stable Outlook	October 2018
Short Term Issuer		National	A1(ZA)		
Long Term Issuer	Last	National	AA-(ZA)	Stable Outlook	July 2023
Short Term Issuer		National	A1+(ZA)		

Operating environment

Country risk

Following the REIT's recent decision to reign back investments into the UK and focus solely on its development pipeline in South Africa, GCR expects the weighting of the portfolio to increasingly shift towards South Africa over the short to medium term. As such, Equites' credit profile remains anchored primarily by its core portfolio holdings in South Africa, although we continue to recognise the diversification benefits to the UK, a more developed market, in our country risk score assessment.

The full list of GCR country risk scores can be found at https://gcrratings.com/risk-scores/.

Sector risk

Similar to the country risk assessment, Equites' sector risk score blends the sector risks of the South African and developed Europe property markets.

The South African commercial property sector has continued to face a number of operating challenges coming out of COVID-19, most notably the rapid global interest rate hiking cycle. Unabated rising utility costs and the increasing unreliability of municipal service delivery will also remain key themes impacting on cash flows. In this regard, many property companies have or will continue to invest in alternative power sources to aid with operations and associated loadshedding costs. Whilst this does temporarily add to funding costs, particularly given the current interest rate environment, it will augment ESG deliverables, which has become a major focal point for both investors and tenants. Similar investments will likely be needed in terms of ensuring water security and the more efficient use thereof. That said, most GCR rated property companies have remained resilient to the economic woes given sound occupancy levels of well-located properties, coupled with healthy leverage profiles. Commercial property values have broadly remained intact with sales achieved largely on par with book values. That said, transactional activity has been partly tempered by high interest rates, which has also weighed on share prices in the listed property sector. Accordingly, new equity issuances from listed property companies are likely to remain limited, with reduced payout ratios and dividend reinvestment options a preferred source of funding for at least maintenance capex. We do expect a mild recovery in the economic environment as interest rates moderate towards the end of 2024, but this is only likely to translate into better property related performances well into 2025. We believe that logistics and convenience-based retail will remain the most attractive segments, as well as any new high grow niche sectors. The office sector remains under strain, although prime properties will likely benefit from a flight to quality.

Strong property fundamentals for developed Europe commercial property remain underpinned by global gateway cities, robust and liquid capital markets and a diverse investor base. France, Germany and the UK in particular are considered as safe-haven investment markets, where the majority of cross-border capital remains allocated. The uncertain economic outlook and higher interest rates have continued to weigh on investment activity into 2024 and could remain low until the start of 2025. Positively, pricing conditions have seen some stabilisation, but differ widely between markets and property type. This has encouraged some increased market activity, but most market players are only likely to break out from the wait-and-see approach once the projected interest rate cuts materialise, which could also give rise to a stronger rebound in values. The flight to quality and an emphasis on ESG requirements continue to dominate investment decisions for both occupiers and investors as the EU and the UK will be phasing in new energy efficiency standards on properties. In this regard, ESG reconfigurations to older assets may only be viable if construction costs fall enough to support refurbishments. This will continue to underscore a rental gap between new prime asset and older properties. In the current market conditions, debt lenders remain selective and have tightened credit standards. Banks have shown appetite to refinance customers with established relationships but have been reluctant

to grow their property loan books. On average commercial property funds in Europe are not overly leveraged, meaning that refinancing and default risks will likely be isolated.

The logistics leasing market remains solid in developed Europe markets, with positive rental growth expectations albeit at more moderate levels compared to the exponential growth evidenced during the pandemic years. Demand still outpaces supply in this sector, but developers are curtailing new builds as leasing activity cools somewhat, as well as the high construction and lending costs. Sustained demand for prime office space in key cities continues to underscore low vacancies and sound rental growth as high-quality new space remains scarce. However, more broadly, office leasing is likely to remain somewhat sluggish, reflecting weak economic growth and the shift towards new workplace strategies. The retail sector should benefit from lower inflation and rising real wages. Whilst e-commerce penetration is high, consumer buying habits reflects a cultural preference towards physical stores in certain regions. With the residential sector facing structural undersupply in addition to affordability constraints on residential mortgages, upward pressure on rental accommodation is expected to remain unabated. Additionally, more investor interest in niche sectors such as data centres, health care and education is likely.

Details of the sector risk scores are outlined in GCR's Sector Risk Score reports, available for download at https://gcrratings.com/risk-scores/.

Business profile

Portfolio quality

The REIT continues to grow and modernise its logistics portfolio through developments, and with occasional strategic acquisitions. Equites' portfolio reports strong operational metrics and has repositioned more towards South Africa following management's decision in the prior financial year to partially rotate out of the UK. As of 28 February 2024 (financial 2024), Equites' portfolio was independently valued at ZAR28.4 billion (USD1.6 billion) from ZAR27.6 billion in financial 2023. This was achieved despite significant asset disposals concluded of ZAR3.6 billion (including land) in the UK and ZAR1.2 billion in South Africa, with a further c.ZAR2.2 billion that could materialise in financial 2025. Positively, sale values have on average been close to book value. Growth in portfolio was driven by additional new builds domestically combined with an upward revaluation on both the South African and UK portfolios of 4.2% and 2.1% (in GPB) respectively. Equites' also remains intent to exit its 60% partnership in Equites Newlands Group Limited (ENGL)- the platform that was established for UK development opportunities with Newlands Development LLP.

Exhibit 1: Portfolio progression

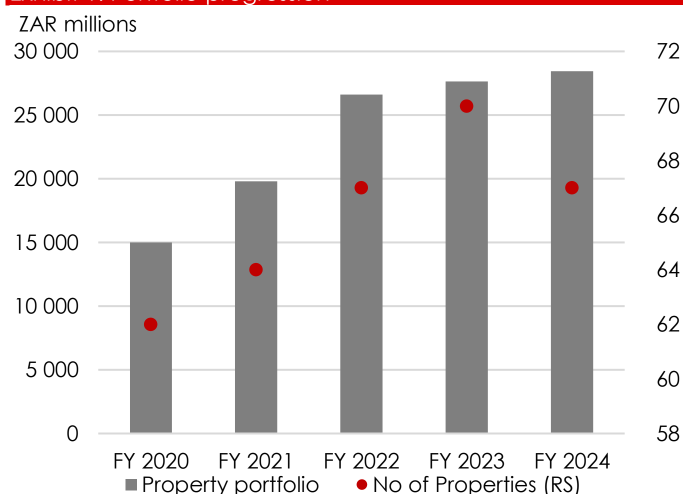
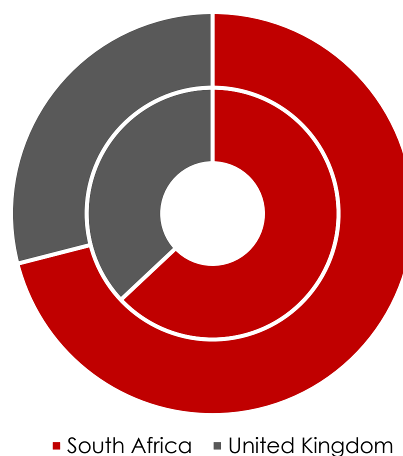


Exhibit 2: Geographic split by value FY 2024 (FY 2023) %



The REIT's growth strategy is centred on reinvesting the proceeds of sales into new South African developments aligned with stringent ESG objectives, which should continue to improve the quality of its portfolio. In South Africa, capex of ZAR1.4 billion in new developments (and land acquisitions) is projected for financial 2025. A sizeable portion of this is still in relation to the Shoprite joint venture (JV) developments and extensions. Equites has sought to enter into JVs to enable new and larger acquisitions/ developments without placing financial strain on the REIT. Aside from the immediate portfolio growth and partial funding afforded, the structures established to undertake these transactions also provide a solid base off which to participate in further transactions. Development activity is projected on average at around R1bn annually over the medium term. While the high level of development activity does imply some additional risk, GCR takes comfort from the REIT's successful track record, having developed nearly half of its property portfolio. Other mitigating factors include the high proportion of preleasing and the short construction length for logistics assets in the context of adapting to markets and capex outlay. Further, while the REIT does pursue some speculative projects in South Africa, only two to three speculative builds may be on the development schedule at any point in time.

Exhibit 3: Vacancy progression

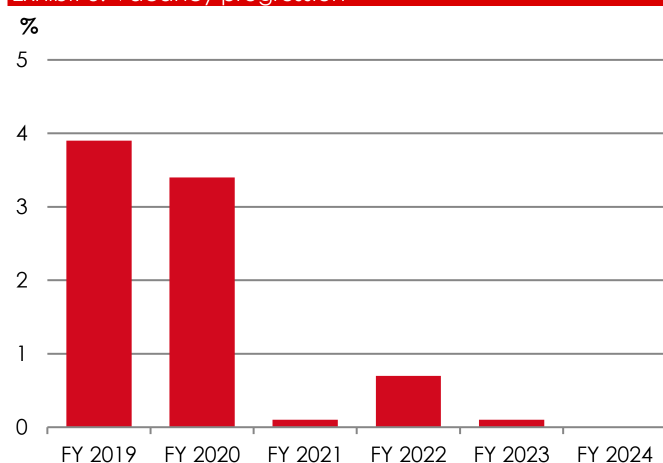
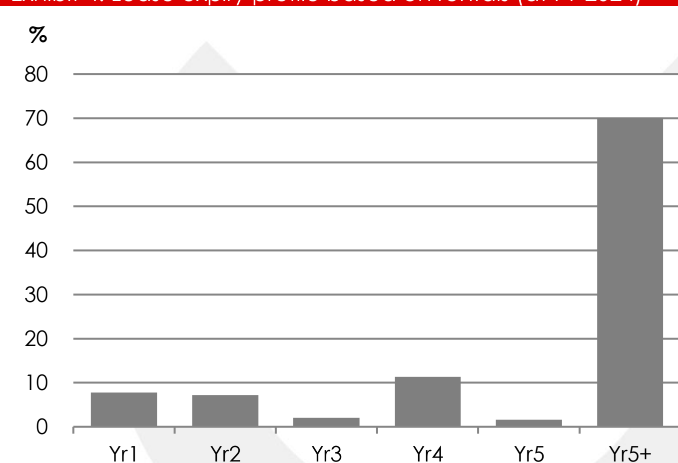


Exhibit 4: Lease expiry profile based on rentals (at FY 2024)



The REIT's properties are well-located in connectivity nodes across key trade hubs in South Africa and the UK. Underpinned by robust demand and supported by the high ESG credentials of its properties, Equites has maintained high occupancies and was fully let at financial 2024. This has also underpinned strong tenant credit quality, with 97.7% of revenue derived from A-Grade tenants, largely multi-nationals, including Shoprite, DSV, Amazon, Röhlig-Grindrod, Digistics, Puma and The Foschini Group. The quality of tenants and some shared asset ownership partially mitigates the increased tenant concentration risk evident in the portfolio. In South Africa, leases benefit from average annual escalation rates of 6.2%, with five-year rent reviews in the UK, which together with the weighted average lease expiry profile of 12.6 years supports resilient long-term income growth. On account of the growth in the portfolio size, and triple-net lease nature, net property-related income has remained robust, increasing by 13% in financial 2024 (5-year CAGR: 24%).

Sustainability

ESG factors are an overall neutral consideration in our credit rating analysis. That said, we recognise the REIT's sustainability efforts. Equites has a clearly articulated ESG framework and targets, aligned to a long-term goal of achieving EDGE Zero Carbon certification on all its SA properties by 2040. In this regard, the REIT has submitted it first SA building for this certification. As it progresses towards this goal, in the current baseline specification the REIT ensures that all new SA developments have at a minimum an EDGE Advanced certification, which aims to achieve a minimum efficiency of 40% in energy and water metrics. 83.3% of all UK buildings are BREEAM certified. As such, Equites' remains committed to expanding its renewable energy projects, with 20.2 MV solar capacity at present to increase by 8.3MV

by 2026. The REIT is also part of the pilot project on energy wheeling in the Cape Town. As an extra pilot project for water management measures, Equites plans to install two ecological wastewater treatment plants to improve water reuse efficiencies.

Financial profile

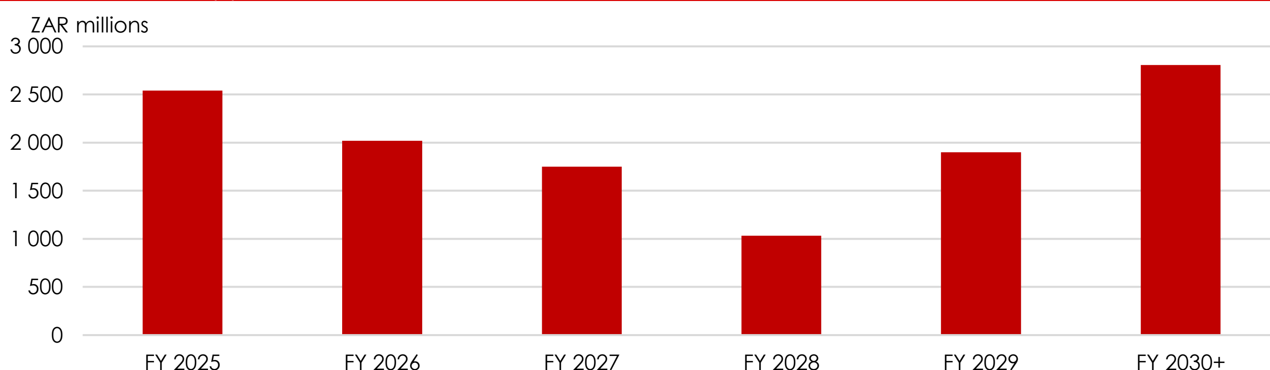
Leverage and capital structure

The developments and acquisitions underpinning Equites' growth are mainly funded through debt. Historically, part of the capex funding has also largely come by way of frequent equity raises, which together with the substantial enhancement in the value of the property portfolio kept the LTV at very conservative levels of around 30%. However, Equites' LTV increased to 39.7% in financial 2023, as result of pressures on UK property values. In addition, the REIT did not raise new equity given the discount to net asset value at which its shares trade (similar to most peers in the sector). In financial 2024, the LTV remained steady at 39.6%. GCR expects that the already-committed or engaged asset sales will be used to fund the ongoing development activity and partially deleverage, with the LTV to remain moderately higher than previously estimated, but just below 40%.

We expect that interest coverage will remain pressurised at around 2.2x over the next 12-18 months, given the high interest rate environment and because of the income foregone from disposed assets, whilst newly completed buildings are tenanted. That said, coverage is anticipated to strengthen over the medium term supported by growing cash flows and some moderation in the development pipeline. Similarly, the net debt to operating income ratio is likely to trend at the current high levels over the next year (8.0x in financial 2024) given the earnings drag of the new developments but should moderate thereafter.

Equites' debt maturities are well spread, with no more than 23% maturing in any year. Moreover, the REIT has demonstrated consistent and frequent unsecured debt capital market access and should continue to benefit from strong appetite to refinancing maturing notes. During financial 2024, Equites placed its first 7-year unsecured note. DMTN capital represents 34% of its debt funding structure, which we view as a credit positive as it diversifies capital access and enhances financial flexibility beyond secured means. We also note a number of green loans in its portfolio. Some of these are directly linked to the EDGE certification on certain properties, but in South Africa the trend has been to measure the impact on a portfolio wide basis, with the loans being general purpose loans.

Exhibit 5: Debt maturity profile at FY 2024



Liquidity

We assess Equites' liquidity as adequate, based on our estimate that the REIT's liquidity sources will likely cover uses by 1.3x over the next 12 months, albeit that the ongoing need for development funding does imply continued liquidity pressure given the 100% dividend payout ratio. Our assessment does also positively consider the high level of unencumbered properties (50.6% in financial 2024) which can support liquidity via sales or raising secured bank debt. Moreover, covenant headroom remains ample.

Principal liquidity sources include:

- ZAR2.3 billion in available cash and unutilised committed facilities as at February 2024.

- DRIP proceeds of ZARR337 million.

- Our estimate of ZAR2.8 billion from the disposal programme (which largely incorporates already sold properties).

Principal liquidity uses include:

- ZAR2.5 billion in debt is maturing in financial 2025.

- development spend estimated at around ZAR1.4 billion.

Comparative profile

Group support

Group support is not applicable to the assessment.

Peer analysis

The peer analysis is neutral to the ratings.

Rating adjustment factors

Structural adjustments

No adjustments were made to the Anchor Credit Evaluator in arriving at the ratings.

Instrument ratings

No adjustments for instrument ratings are applicable.

Glossary

Country Risk	The range of risks emerging from the political, legal, economic and social conditions of a country that have adverse consequences affecting investors and creditors with exposure to the country, and may also include negative effects on financial institutions and borrowers in the country.
Committed Facility	A line of credit extended to a borrower that is guaranteed to be available for a specified period. The lender is obliged to lend the predetermined amount for the defined period under the terms of the agreement.
Covenant	A provision that is indicative of performance. Covenants are either positive or negative. Positive covenants are activities that the borrower commits to, typically in its normal course of business. Negative covenants are certain limits and restrictions on the borrowers' activities.
Currency Risk	The potential for losses arising from adverse movements in exchange rates.
Diversification	Spreading risk by constructing a portfolio that contains different exposures whose returns are relatively uncorrelated. The term also refers to companies which move into markets or products that bear little relation to ones they already operate in.
Dividend	The portion of a company's after-tax earnings that is distributed to shareholders.
Facility	The grant of availability of money at some future date in return for a fee.
Hedge	A form of risk management aimed at mitigating financial loss or other adverse circumstances. May include taking an offsetting position in addition to an existing position. The correlation between the existing and offsetting position is negative.
Interest Cover	Interest cover is a measure of a company's interest payments relative to its profits. It is calculated by dividing a company's operating profit by its interest payments for a given period.
Issuer	The party indebted or the person making repayments for its borrowings.
JSE	Johannesburg Stock Exchange. A stock exchange typically represents a market with a trading-floor or a screen-based system where members buy and sell securities.
Lease	Conveyance of land, buildings, equipment or other assets from one person (lessor) to another (lessee) for a specific period of time for monetary or other consideration, usually in the form of rent.
Lessee	The party that enjoys temporary use of a corporeal thing.
Leverage	With regard to corporate analysis, leverage (or gearing) refers to the extent to which a company is funded by debt.
Liquidity	The speed at which assets can be converted to cash. It can also refer to the ability of a company to service its debt obligations due to the presence of liquid assets such as cash and its equivalents. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.
Long Term Rating	See GCR Rating Scales, Symbols and Definitions.
Market Risk	Volatility in the value of a security/asset due to movements in share prices, interest rates, currencies, commodities or wider economic factors.
Maturity	The length of time between the issue of a bond or other security and the date on which it becomes payable in full.

Portfolio	A collection of investments held by an institutional investor. They may include stocks, bonds, futures contracts, options, real estate investments or any item that the holder believes will retain its value.
Rating Horizon	The rating outlook period
Rating Outlook	See GCR Rating Scales, Symbols and Definitions.
Real Estate	Property that consists of land and / or buildings.
Refinancing	The issue of new debt to replace maturing debt. New debt may be provided by existing or new lenders, with a new set of terms in place.
REIT	Real Estate Investment Trust. A company that owns, operates or finances income-producing real estate.
Short Term Rating	See GCR Rating Scales, Symbols and Definitions.
Vacancy	In commercial property, usually expressed as a percentage of unoccupied floor space in relation to the GLA.
Valuation	An assessment of the property value, with the value being compared to similar properties in the area.
WALE	Weighted average lease expiry.

Salient points of accorded ratings

GCR affirms that a.) no part of the rating process was influenced by any other business activities of the credit rating agency; b.) the ratings were based solely on the merits of the rated entity, security or financial instrument being rated; and c.) such ratings were an independent evaluation of the risks and merits of the of the rated entity, security or financial instrument.

The credit ratings have been disclosed to the rated entity. The ratings above were solicited by, or on behalf of, the rated entity.

The rated entity participated in the rating process via in person interaction and/or via online virtual interaction and/or via electronic and/or verbal communication and correspondence. Furthermore, the quality of information received was considered adequate and has been independently verified where possible. The information received from the rated entity and other reliable third parties to accord the credit ratings included:

- Exchange Rate Source: https://www.bloomberg.com/markets/currencies
- The audited annual financial statements to 28 February 2024 (plus four years of audited comparative numbers)
- The 2024 integrated report
- A breakdown of utilised and available debt facilities at February 2024 and June 2024
- Analyst Presentations, SENS announcements and roadshows
- 2-Year cash flow forecasts
- Property portfolio breakdown at February 2024

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