

Layer It On — The Essentials of Rating Project Subordinated Debt

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■ Summary

It is a basic tenet of project finance that sponsors are motivated to take full advantage of a project's ability to generate sustainable cash flow. This is accomplished in part by designing the project's capital structure with as much debt as possible, thereby minimizing the required up-front cash equity contribution. The inherent credit risk derived from this sponsor inclination is one of overleveraging. The potential volatility of a project's cash flow stream will largely determine its capacity for debt leverage, particularly at a given rating level. All else equal, the greater the cash flow volatility, the lower the project's debt capacity. Many well-conceived and otherwise strong projects fail to achieve investment-grade senior debt ratings due solely to excessive debt levels. How, then, can a project sponsor optimize the credit quality of the senior project debt while providing the minimum acceptable level of equity capital? One approach is to integrate a tier of appropriately structured subordinated debt (sub debt) into the project's capital structure. The inclusion of sub debt in the capital structure of a project entity can be a beneficial financing tool from the perspective of both the project sponsor and the senior lenders. By adding a layer of sub debt, the credit quality of the senior project debt will most likely be enhanced (or at least not impaired). At the same time, this addition of layer financing will allow a higher aggregate amount of project debt to be issued and thereby reduce the required amount of more costly equity capital. This report will describe the methodology Fitch Ratings employs in assessing and rating project debt when sub debt is utilized in the financing structure. Two case studies are included toward the end of this analysis to illustrate Fitch's methodology.

Fitch has rated a number of project transactions that include at least two classes of debt (senior and subordinated) in a wide range of sectors. While historically the focus has been on the senior project debt, increasingly Fitch is being asked to also rate the sub debt of project entities. Once provided primarily by sponsors as an economic alternative to equity, project sub debt is being increasingly funded by third-party investors. As the universe of subordinated project lenders expands, the variety of lender perspectives and objectives expands, leading to an array of subordination terms and conditions. While subordination provides senior lenders priority rights on debt service payments and security interests, the degree or level of subordination can vary greatly, depending upon the specific terms of the sub debt. Moreover, the level of subordination will have a considerable effect on the relative credit quality of the different classes of debt. A key question in determining the level of subordination is whether the sub debt is comparable to conventional corporate sub debt (clearly a debt instrument, albeit junior to senior debt) or is deeply subordinated (many equitylike characteristics).

As a result of its equitylike qualities, deeply subordinated debt affords the senior debt a greater level of protection relative to conventional sub debt. Since the vast majority of outstanding project sub debt is deeply subordinated, it follows that project sponsors are predominantly interested in optimizing the credit quality of the senior project debt. Accordingly, an underlying premise of this report is that project sub debt should be structured to be deeply subordinated so as not to impair the creditworthiness of the senior debt.

While sub debt can take various forms within a project finance transaction, the nature of the subordination can be categorized as either contractual or structural. Contractual subordination is derived by explicit agreement between the senior and sub debt holders where both are lending to the same entity. Structural subordination is most frequently observed in cases where different classes of debt holders are each lending to different but related entities, such as an operating project company and its parent holding company. As a case in point, it has become a common practice that once a project is up and running, sponsors seek to monetize future equity distributions by issuing debt at the project's holding company. In such cases, the holding company debt will be structurally subordinated relative to the operating project's debt since the holding company's only source of cash flow will be dividends from the project company. Further, the conditions under which the operating project will be allowed to pay dividends or equity distributions will be established under the financing arrangements with the project's lenders. From an analytical standpoint, little weight is given to whether sub debt is contractually or structurally subordinate, as either one can be classified as conventional or deeply subordinated, depending on the facts and circumstances surrounding the particular financing.

There are three general categories of project sub debt providers. The first category, as mentioned above, consists of project sponsors providing sub debt funding as a substitute for equity. Sponsors may be motivated to provide at least a portion of their capital contribution in the form of sub debt as a result of financial considerations, such as cost of capital, taxes and risk-adjusted rate of return. The second category is institutional investors such as insurance companies and investment funds. These investors are motivated by the prospect of achieving a higher yield than senior lenders. For the potential of earning a higher return, these lenders are willing to subordinate their

claims to the senior lenders and, in doing so, accept a higher level of risk. The third source of project sub debt comes from governmental parties that are interested in advancing infrastructure investment in a specific region or country. Because each of these three classes is motivated by different objectives and risk tolerance, the terms under which each is willing to provide sub debt will vary, which in turn will determine the degree of subordination.

■ Key Terms of Subordination

Deeply Subordinated Debt

The level of subordination is a major factor in determining the relative credit quality between the senior and sub debt. In order to maximize a project's senior debt rating, sub debt must be considered deeply subordinated (i.e., deemed to be essentially equity from the perspective of the senior debt lender). For sub debt to be considered deeply subordinated, senior lenders must have complete control over the financing documents, collateral and the enforcement of default remedies, particularly acceleration. Deeply subordinated debt payments must also be subject to restrictions similar to those on equity distributions to the project sponsors, such as no senior debt defaults and the satisfaction of a minimum senior debt service coverage ratio (DSCR). In the event the project's cash flow is insufficient to service its sub debt, unpaid principal and interest on that debt should accrue indefinitely, and subordinated lenders should have no nonpayment remedies as long as the senior debt is outstanding and has not been accelerated. With regard to the potential of the project filing for bankruptcy protection, there should be assurance that a bankruptcy court will recognize the terms of the subordination. If all these characteristics are present, senior project lenders should be indifferent between deeply subordinated debt and equity.

Deeply subordinated debt can be used not only as a substitute for equity but also to reduce senior debt leverage and improve senior debt service and asset coverage. As such, senior debt credit quality can be enhanced to the extent the layer of deeply subordinated debt reduces the aggregate amount of senior debt needed to finance the project. From the sponsor's standpoint, a tier of sub debt can reduce the amount of required equity and enhance the sponsors' returns, while, again, senior lenders should be indifferent as to whether the balance of the capital structure is composed of deeply subordinated debt and/or equity. As a simple example, two projects are

assumed to have identical operating and financial profiles, except that one is capitalized 75% senior debt and 25% equity, and the second project is capitalized 65% senior, 20% sub debt and 15% equity. If the sub debt tranche is deeply subordinated, the second project will exhibit stronger senior DSCRs and asset coverage. All else equal, the second project therefore would likely be rated higher than the first project, even though the second project has a higher level of “total debt” and less “equity.”

Conventional Subordinated Debt

Transactions in which the sub debt lenders have at least some control over payment triggers, collateral rights, default remedies and financing document decisions will exhibit less difference between the credit quality of the senior and sub debt. In fact, the weaker the subordination provisions, the more the senior debt credit quality will be negatively affected, since the credit analysis will focus on total debt, not simply the senior debt. While the senior debt will still hold priority rights over payment and security, in the event of a payment default of only the sub debt, the senior debt lenders may not fully control their own destiny. If the subordinated lenders have independent default rights and remedies and choose to exercise them, the senior lenders may be forced to take actions they would not have otherwise taken in order to protect their interests. Therefore, when sub debt is conventional, the senior debt should not be viewed in isolation, and the quantitative analysis of the project should include a total or consolidated debt assessment.

Regarding contractual subordination, the terms of subordination will be a matter of negotiation between the different classes of lenders. The key terms that determine the level of subordination (and therefore are the most intensely negotiated) include the following: relative rights to security; voting rights related to waivers and/or amendments of the financing documents; events that trigger a sub debt payment block; the duration of such payment block; and independent default rights and remedies. In these zero-sum negotiations, the weaker the terms of subordination, the less control the senior lenders have over the financing going forward, particularly when the project’s credit fundamentals are deteriorating. For example, if in the event of a sub debt payment default the subordinated lenders have the ability to accelerate their debt (typically after some standstill period), the senior lenders would likely be forced to negotiate a financial restructuring even if the senior

debt is still in compliance. This dilemma would not occur if the sub debt were deeply subordinated.

Returning to the example of the two identical yet differently capitalized projects, if the sub debt in the second project is conventional sub debt, it is appropriate to assess the project (and the senior project debt) from a total debt perspective, instead of simply on a senior debt basis. In this case, the second project’s leverage is higher than in the first project (85% versus 75%) and total DSCRs will obviously be weaker, resulting in the senior rating of the second project being lower than the rating of the first, all else equal.

■ Rating Rationale on Notching Differential

The rating differential between senior and subordinated project debt will depend on a number of factors. In general, the notching between senior debt and sub debt is wider for project finance transactions than corporate finance, due largely to differences in the level of subordination. The preponderance of existing project sub debt is deeply subordinated, while corporate sub debt is principally conventional in nature. Therefore, it is unsurprising that there is wider notching between project senior and sub debt than is witnessed in the corporate arena. For a solid investment-grade senior unsecured corporate rating, the sub debt rating is often one notch lower, reflecting the relatively weak subordination provisions of conventional sub debt. By contrast, project sub debt is usually 2–4 notches below the senior level debt, reflecting the high level of subordination and the significantly higher probability of payment defaults associated with the project sub debt. Cash flow available for debt service in any given year may be sufficient to service the senior debt but not sufficient to also service the sub debt, and there is usually no recourse for the sub debt holders in such an event. It is interesting to note that the narrowing of the senior and conventional sub debt ratings results at the expense of the senior debt rating. In other words, whether the sub debt is conventional or deeply subordinated will influence the senior debt rating to a greater degree than the subordinated rating. As with all sub debt, the notching between project senior debt and sub debt will widen as the senior debt rating moves down the rating scale, since more risk at the senior level results in significantly higher risk for the sub debt holders.

As alluded to earlier, when rating project finance transactions that have multiple layers of debt, Fitch will employ either a top-down approach or a total debt approach, depending on the terms and level of subordination. The top-down method assesses the credit quality of the senior project debt on a stand-alone basis, with no express regard given to the sub debt. This approach is only appropriate when the sub debt is deeply subordinated and therefore does not affect the credit quality of the senior debt. Conversely, when the sub debt is conventional, the senior debt will be analyzed and rated on a total debt basis, and the sub debt rating will be notched down, typically 1–2 notches (depending on the rating level).

Thus far, the discussion regarding the level of subordination focuses primarily on determining the project's senior debt rating. Once the senior project debt has been analyzed and rated, the next step is to determine the appropriate rating for the sub debt. In addition to the level of subordination, a number of other qualitative and quantitative factors will be considered in assigning the sub debt rating. These other factors can be broken down into two broad categories, project-specific characteristics and the explicit structural elements of the sub debt. The following discussion pertains primarily to deeply subordinated debt.

Project-Specific Characteristics

It is important to note that whatever risks are inherent to senior lenders in a particular project, those risks are magnified for subordinated lenders. Hence, it is critical to both the senior and sub debt analysis to assess the fundamental strengths and risks of the project, such as business operating risk, asset quality and financial robustness. The results of such an analysis are used to determine the quality of the cash flow stream available to each class of lenders, which in large part will reveal the project's total debt capacity, at a given rating level. The more stable and predictable a project's cash flow, the greater its total debt capacity, which is beneficial to the sub debt. If, for instance, a project's cash flows are resilient under various stress scenarios, cash available for sub debt service will also be more reliable. If, on the other hand, a project's revenues and/or expenses (and therefore cash flows) are subject to a high degree of volatility, the project's total debt capacity will not be as great. As such, the negative effect of this increased volatility will fall disproportionately upon the sub debt holders.

Factors that determine the quality of a project's cash flow principally center around operating risk and off-take/market risk. In terms of operating risks, Fitch will consider the likelihood of a project not being able to operate on parity with base-case projections, both in terms of output performance and pricing as well as input cost factors. Single-asset projects inherently have a higher level of operating risk than project entities that own a portfolio of assets and enjoy the benefits of diversification. Pertaining to off-take/market risk, Fitch will analyze factors such as counterparty risk as well as the potential for both volumetric and price variability. The best example compares a power project under a fixed- priced power purchase agreement (PPA) with a similar project that sells into a competitive merchant environment. The project with the PPA will likely have a stable and predictable cash flow stream, while the merchant project's cash flow will reflect market price fluctuations, its cost competitive position and the ongoing demand for electricity. Consequently, the project with the PPA will have a greater total debt capacity than the merchant project, all else equal.

Diversification of project assets also enhances the quality of consolidated cash flow since the potential variations in each asset's performance is muted when part of a larger portfolio. An example of project asset diversification would include financing transactions in which the debt issuer is a special-purpose holding company with equity interests in a collection of power projects, each with its own senior project-level debt. Under such circumstances, the issuer's revenues consist solely of equity distributions from the individual projects, making the issuer's debt deeply subordinate to the project-level debt. Despite the deeply subordinated nature of the issuer's debt, it is possible to rate the debt investment grade due substantially to the quantitative and qualitative benefits derived from diversification. Consolidated cash flow from the portfolio will be more stable and predictable than that of any individual project because of diversification.

Subordinated Debt Structural Features

Once the analysis of the project's cash flow is completed, the final step in determining the appropriate number of notches between the senior and the sub debt is to review the sub debt's key structural parameters. In particular, the size, maturity and amortization schedule will be considered. Each of these factors will have an effect on the quantitative measures and, therefore, may influence the rating on the sub debt. The sizing of the sub debt should be a

function of the project's total debt capacity, at a given rating level. To the extent the amount of the deeply subordinated debt overleverages the project's cash flow, the differential between the senior debt and the sub debt will widen.

The maturity and amortization of the sub debt is weighed in relation to the senior debt and also in their own right. Bullet maturities, or those with little annual amortization, translate into higher risk to the sub debt lenders, due to refinancing risk and higher equity distributions to the detriment of the sub debt. The maturity and amortization schedule will also be judged in relation to events in the future that may alter the project's ability to generate cash flow, such as the expiration of an off-take or fuel supply contract. Like project debt in general, if the maturity of the sub debt extends into a merchant period, the subordinated DSCRs should be markedly higher during that period to compensate for the loss of stable contractual revenues.

The level of sub debt payment triggers, such as a minimum senior DSCR, will also be considered. All else equal, the higher the threshold, the more detrimental it is to the sub debt lenders and vice versa. For a project that consistently generates annual senior DSCRs of 2.5 times (x)–3.0x, there is no material difference to either class of lender between a senior DSCR trigger of 1.2x and one of 1.5x, since ample cushion already exists. However, there is a great deal of difference between those two triggers to the sub debt if annual senior DSCRs are volatile under stress scenarios, perhaps fluctuating between 1.3x–2.0x.

Just because sub debt ranks junior to the senior debt does not mean the sub debt should not benefit from structural enhancements senior project lenders take for granted, such as the equity distribution lock-outs described earlier and a debt service reserve account (DSRA). Sub debt lenders should have a mechanism to lock-out equity distributions the same way senior debt lenders can stop payments to both sponsors and subordinated lenders. It is also standard in project finance transactions to have at least a six-month DSRA available solely for the benefit of the senior lenders. The replenishment of the senior DSRA, if drawn, would occur in the flow of funds prior to sub debt service. The existence of a dedicated subordinated DSRA is advantageous to the sub debt lenders since liquidity is even more critical to sub debt lenders than senior debt lenders because the cash flow cushion is less, reducing the margin for error.

(Note: a typical project flow of funds is as follows: 1) operating expenses; 2) senior debt service; 3) senior DSRA; 4) sub debt service; 5) subordinated DSRA; and 6) equity distributions.)

Recent subordinated project finance transactions have taken different approaches to incorporating security interests. One approach is for sub debt lenders to receive a junior security interest in the operating company's assets and contract rights with the first-priority interest being held by the senior lenders. Another approach is to grant a security interest in the holding company's stock and its ownership interest in the operating company to the subordinated lenders (senior lenders still have first-priority security interest in the operating company's assets and rights). While security for the subordinated lenders will be noted in Fitch's analysis, it will most likely not have an effect on the rating. Security principally influences ultimate payment and recovery in the event of default, while presently Fitch's project finance ratings reflect the probability of timely principal and interest.

■ Case Studies

The Alameda Corridor Transportation Authority

The Alameda Corridor Transportation Authority (ACTA) is a joint powers authority formed to facilitate the financing and construction of a 20-mile, multitrack rail corridor linking the Port of Long Beach (POLB) and the Port of Los Angeles (POLA) with the Los Angeles central rail yards. Together, these two ports, POLB and POLA, form the San Pedro Bay, which is the world's third-largest container port complex. Approximately 50% of the containerized cargo that flows through the San Pedro Bay's ports is transferred via rail to destinations east of California. Therefore, the ACTA project was conceived to ease truck congestion on local roadways, expedite the transfer of container cargo and facilitate national economic growth.

The \$2.4 billion of overall project costs was funded primarily through bond issuance. To finance construction of the corridor, ACTA issued approximately \$1 billion of senior lien revenue bonds (\$494 million tax-exempt series 1999A and \$505 million taxable series 1999C) and \$166 million of subordinate lien revenue bonds (\$21 million tax-exempt series 1999B and \$145 million taxable series 1999D). The U.S. Department of Transportation

(U.S. DOT) provided a \$400 million loan. This loan represented mezzanine debt, which was subordinate to the senior lien bonds but senior to the subordinate bonds. Additionally, the two ports contributed approximately \$400 million of equity to this project, some of which was reimbursed with bond proceeds, but the majority will be repaid after debt service and scheduled loan payments.

Fitch issued an 'A' rating on the senior lien bonds and a 'BBB-' rating on the subordinate lien bonds on Dec. 24, 1998. Although the federal loan was not rated, Fitch did evaluate the loan transaction documents. Fitch determined that the U.S. DOT federal loan was contractually subordinate to the senior lien and functioned as equity with extendable repayment provisions. The loan's restrictive terms limited the dollar amount of senior lien and subordinate lien bonds to a maximum of \$1 billion and \$300 million, respectively. Because ACTA was a start-up project without any operating history, the federal government's financial assistance allowed the project's level of debt to remain proportionately lower, and that helped to facilitate an investment-grade rating for both the senior and subordinate lien revenue bonds.

Fitch rated the subordinate lien revenue bonds four notches below the senior lien bonds ('A' versus 'BBB-') reflecting the terms of subordination, dollar amount of the senior lien bonds and terms of the federal loan. Using the top-down approach, Fitch evaluated the terms of subordination and the overall project fundamentals. The subordinate bonds were determined to be deeply subordinate to both the senior lien bonds and the federal loan, containing no controls over the financing documents, default remedies or structural triggers. Quantitatively, approximately \$1.4 billion of debt is senior to the subordinate bondholders, and ACTA has no proven historical cash flow. Although the POLA and POLB are both severally obligated to make short-fall advances to ACTA (limited to an amount not greater than 40% of the bond and federal loan debt service in any given year), if the project must rely on these advances, then subordinate bondholders are in a much weaker position due to the level of senior debt. Qualitatively, Fitch considered several factors in the ratings process, including world economic cycles, shipping industry consolidation and potential delays in construction timetables.

Ultimately, Fitch provided an investment-grade rating to both the senior and subordinate lien revenue

bonds. Normally, a start-up project of ACTA's scale, financed entirely with senior lien revenue bonds, would probably not receive an investment-grade rating because it would be leveraged too highly. In treating ACTA's debt more favorably, Fitch considered that senior bondholders would benefit greatly from the insulation provided by the \$400 million U.S. DOT loan, treated as quasiequity, the ports' \$400 million equity component and the deeply subordinate lien revenue bonds.

AES Drax

The rating history of the AES Drax project finance transaction is illustrative of how the rating differential between senior and sub debt widens as credit quality deteriorates. Drax is an approximately four-gigawatt (GW) coal-fired power plant in the UK acquired by AES Corp. and financed via a nonrecourse project finance structure that included both senior bank debt and sub debt. In July 2000, a partial refinancing of the original project debt took place, replacing a portion of the senior bank debt with senior bonds (together, senior debt). The refinancing resulted in GBP1.3 billion of senior debt at Inpower Ltd. and AES Drax Holdings Ltd. (the senior debt issuers) and GBP267.0 million of subordinate debt (the high-yield debt) issued at the holding company, AES Drax Energy Ltd.

The high-yield debt is deeply subordinated to the senior debt for a number of reasons. The high-yield debt was issued by the holding company and is structurally subordinate to the senior debt. The senior lenders hold a first-priority security interest in the projects' assets, while the security interest held by the high-yield debt holders is limited to the shares of the holding company (this interest does not include the shares of the senior debt issuers). Enforcement rights are further limited (i.e., standstill period and transferee eligibility) by the intercreditor agreement. The high-yield debt is afforded no default rights and remedies against the senior debt issuers. The high-yield debt is serviced by distributions from the senior debt issuers, and such distributions are subject to certain restrictions, including the absence of senior debt events of default as well as minimum historical and forecasted senior DSCRs.

This degree of subordination can be explained by the fact that the high-yield debt was issued after the original GBP1.3 billion senior debt had already been closed and funded, such that the senior lenders required equity-type characteristics for the new debt. The shorter maturity of the sub debt (10 years for the

notes versus 20 years and 25 years for the senior secured bonds) was acceptable to senior lenders and bondholders due to the degree of subordination.

At the time of the refinancing in July 2000, the senior debt was rated 'BBB-' and the subordinate debt was rated 'BB'. The two-notch differential reflected the relatively high projected DSCRs of both the senior and sub debt (based on the then forecasted power prices in the UK), as well as the relatively short maturity of the subordinate debt. Subsequently, the Drax power project was negatively affected by reduced insurance coverage following the tightening of the insurance market post-Sept. 11 (as well as the loss history at Drax itself) and a marked deterioration of actual and projected DSCRs resulting from a sharp decline in the outlook for UK merchant power prices. This combination of events led to downgrades of both the senior and the sub debt in November 2001 from 'BBB-'/ 'BB' to 'BB+'/'B+', respectively, with the ratings kept on Rating Watch Negative.

The sub debt was downgraded by two notches, resulting in a three-notch spread between the senior and sub debt ratings. The increased rating differential was merited, because the reduced insurance coverage

created a senior debt event of default that blocked distributions to the holding company. Additionally, the wider notch differential reflected greater exposure of the high-yield debt to merchant power price risk. In fact, the February 2002 high-yield interest payment was met out of the debt service reserve account, as the technical event of default on the senior debt was not waived in time to allow distribution. Subsequently, the technical event of default was waived, but the UK power market continued to deteriorate putting further pressure on the high-yield rating. The ratings were further downgraded to 'BB'/'CCC' in August 2002 as lower power price forecasts resulted in a breach of the forward-looking cover ratio, creating the conditions for a second successive cash lock-up at a time when the DSRA was largely depleted. In both instances, sufficient cash was generated by the project to meet the high-yield interest payment, but the structural protection of senior lenders effectively restricted such payment. The current 'CCC' sub debt rating reflects AES Corp.'s recent injection of cash sufficient for AES Drax Energy Ltd. to meet its Aug. 30, 2002 debt service payment. AES Corp. is under no obligation to provide financial support, and it is uncertain whether additional support will be made available to AES Drax Energy Ltd. for future debt service payments.

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