

Rating Object	Rating Information	
<b>KINGDOM OF SPAIN</b>  Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Assigned Ratings/Outlook: <b>BBB+ /positive</b>	Type: Follow-up Rating, unsolicited
	Initial Rating Publication Date: Rating Renewal:	30-09-2016 01-09-2017
	Rating Methodologies:	"Sovereign Ratings"

## Rating Action

Neuss, 01 September 2017

Creditreform Rating has revised its outlook on the Kingdom of Spain to positive from stable and affirmed the unsolicited long-term sovereign rating of "BBB+". Creditreform Rating has also affirmed Spain's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "BBB+".

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## Key Rating Drivers

1. Strong institutional framework and reform-oriented policy-making; while continued effort to re-establish reform momentum is needed, Spain has shown one of the most ambitious reform agendas in the euro area so far
2. Economic recovery has firmed, driven by brisk consumption, investment and export growth; pace of economic expansion is set to stay strong this year – beyond 2017 we expect growth to slow, but to remain robust
3. Macroeconomic imbalances have continued to unwind; still high unemployment and relatively low labor and firm productivity weigh on medium-term prospects for the Spanish economy
4. Limited fiscal leeway due to very high public debt, which is likely to decline only gradually as we expect fiscal consolidation to advance on the backdrop of strong economic performance and declining interest expenditure
5. Despite recent improvements on the back of the fourth consecutive current account surplus, Spain is heavily indebted towards the rest of the world, displaying one of the most negative NIIPs

## Reasons for the Rating Decision

Creditreform Rating has revised its outlook on the Kingdom of Spain to positive from stable. The positive outlook is underpinned by our expectation that (i) the ongoing economic recovery and robust growth will be maintained in the medium term; (ii) the imbalances continue to unwind, in particular pertaining to the labor market, the banking sector, and Spain's external position with the rest of the world; and (iii) the headline deficit continues to decline and the authorities will adhere to their commitment of reducing the very high debt levels.

We affirm the Kingdom of Spain's credit rating, which continues to be backed by its strong institutional setup. As measured by the World Bank's World Governance Indicators (WGI), the sovereign is on par with the euro area average when it comes to government effectiveness, but somewhat lagging as regards WGI indicators such as voice and accountability, rule of law and control of corruption. Notably, Spain moved up one place in the government effectiveness ranking (from rank 33 to 32/209), and also improved on the voice and accountability score, now standing at rank 44 (last year: 49/209). In general, we believe that the Spanish economy benefits from euro area membership, which entails broader and deeper capital markets as well as advantages associated with the euro as a reserve currency and the ECB's monetary policies.

The sovereign's key credit strength lies in its macroeconomic performance and its prosperous and diversified economy. With USD 1.23tr, Spain is the fifth largest economy in Europe and ranks 14th worldwide in terms of nominal GDP. We regard the Spanish economy as highly productive as reflected by its per-capita income of USD 36,416 (2016, in PPP terms). Hence, the country's ability to absorb exogenous shocks compares well to our A-rated sovereigns. Its economy features a strong services sector, with a dominant wholesale/retail trade and tourism segment (Q1-17: 22.5% of GVA). It has to be noted that the latest readings reveal a decrease in the construction sector's GVA, having halved from 10.5 (Q4-09) to 5.3% of GVA (Q1-17) – on par with the euro area average.

Spain's strong economic recovery has remained in place. After GDP growth had accelerated to 3.2% in 2015, the Spanish economy was able to maintain this pace last year, as GDP rose at the same rate. Thus, Spain achieved one of the highest growth rates in the euro area again, thereby outpacing by far the EA-19 average (1.8%) as well as the EU-28 average (1.9%). While annual average growth in 2014-16 posted at a strong 2.6% (2009-13 average: -1.8%), it has only recently become more broad-based, with domestic demand and net trade both contributing to Spain's economic expansion. Robust private consumption spending and investment, which were up 3.2 and 3.1% respectively (2015: 2.9 and 6.0%), still led the recovery; but the contribution of net external demand also turned positive, adding 0.5 p.p. to GDP growth (2015: -0.1 p.p.).

To be sure, external factors such as subdued inflation, a comparatively weak euro, and favorable financing conditions largely driven by the ECB's expansionary monetary policy stance have all been and still are supportive of consumption, investment and export growth. Importantly, the ambitious structural reforms of the past six years continue to have beneficial effects on the country's macroeconomic performance. The labor market, financial sector, fiscal and other structural reforms have facilitated the adjustment of macroeconomic imbalances which have continued to unwind.

Firstly, the labor market situation has improved significantly. The annual average of the unemployment rate dropped from 22.1% in 2015 to 19.6% in 2016 – now having declined by an impressive 6.5 p.p. as compared to 2013. That said, the Spanish economy has some way to go, as it still displays the second highest unemployment rate in the EU-28, potentially dragging down household spending and potential growth going forward. Also, the share of temporary contracts has climbed to a high 22.3% over the recent years (Q1-16: 21.6%), albeit standing well below the levels seen before the crisis (Q2-06: 28.3%).

On the positive side, long-term and very long-term unemployment is falling, which posted at a high 9.5 and 6.5% respectively, down from 11.4 and 7.6% in 2015. The same holds for youth unemployment which remained on its downward trajectory, with unemployment of workers under 25y declining from 48.3 to 44.4% in 2015-16.

Secondly, Spain has come a long way in improving its cost competitiveness. According to AMECO data, real unit labor costs fell by another 0.7% in 2016, having already declined by 4.6% in 2010-15 (EA-19: 0.0 and -1.0%, respectively). These competitiveness gains came mainly on the back of modest wage growth. Last year, real compensation per employee decreased by 0.3% and has grown by only 1.0% since 2010 (EA-19: 2.8%).

However, labor productivity per hour worked stands below the EU-28 average, despite having ticked up from 97.3 to 97.9% in 2015-16. At the same time, structural and regulatory barriers still appear to be at the root of the problem of relatively weak firm productivity, as small enterprises - which tend to have a lower productivity than corporates in comparable economies - dominate the Spanish corporate sector. A case in point is the Doing Business report which ranked the country at 32. Admittedly, Spain has moved up one place (DB16: rank 33), but continues to compare relatively poorly to peers, in particular as regards the procedures, time, and costs to start a business; here, the World Bank found that there even has been a deterioration relative to other economies (down six places to rank 85). Moreover, Spain's innovation level remains comparatively low. As measured by the EU Innovation Scoreboard 2017, Spain's innovation performance is below the EU average, the gap having widened in 2010-16.

Thirdly, a modest recovery in the housing market seems to be underway. Thus, Spanish house price growth has accelerated since Q2-16 and exhibited yearly growth rates of at least 3.9% in every quarter. Looking forward, house prices are set to remain on their upward path on the backdrop of the favorable labor market development and the increase in building permits. In this year's first quarter, house prices moved up by 5.3% y-o-y.

Fourthly, the private sector has made large strides in deleveraging as Spanish private sector debt is now on par with the euro area average. Over the past year, debt consolidation made progress, mainly driven by non-financial corporations (NFCs) which reduced their debt by 5.4 p.p. to 107.4% of GDP between Q4-15 and Q4-16, while private household debt fell from 71.6 to 68.2% of GDP. In 2017 the private sector started the year as it finished 2016, further strengthening its financial position with private household debt decreasing to 67.2% of GDP in the first quarter and NFC indebtedness to 107.1% of GDP – now standing below the euro area average of 109.7% of GDP.

Finally, efforts to clean up the crisis legacies in the banking sector are ongoing and headway has been made. According to EBA data as of Q1-17, banking sector performance metrics have further improved. Since Q1-16 the loan-deposit ratio has decreased by 4.0 p.p. to 116.9%. Capital buffers point to a broadly resilient banking sector and were virtually flat year-over-year, as the CET1 capital ratio slightly declined to 11.9% (EU: 14.1%), after 12.1% in Q1-16. Furthermore, the bank's asset quality benefited from the economic recovery and the concurrent reduction in unemployment, as well as from private sector deleveraging. Banco de Espana data reveals that the amount of so-called

doubtful loans amounted to EUR 111.8bn in Q1-17, EUR 17.5bn lower than a year before and 43.3% below its peak in Q4-13. The NPL ratio fell from 9.99% in Q1-16 to 8.83% in Q1-17. Meanwhile, lending activity is picking up, although the outstanding stock of MFI loans to the private sector is still declining. At the end of Q2-17, the outstanding amount of NFC credit came in 4.2% lower than a year before, but the decline is losing momentum. By the same token, the outstanding amount of household loans decreased by approx. 1.5% per month throughout 2017. Better credit availability, especially for SMEs, is mirrored by survey data. The recent ECB SAFE shows that only 9% of Spanish SMEs cited problems in access to financing, the lowest reading since 2009 (EA-19: 9%). In addition, lending rates of new NFC loans are coming down, a loan up to EUR 1m (maturity 1-5y) posted at 2.51% in Jun-17, down from 4.57% in Jun-14 and at about the same level as in Germany (2.57%).

In June 2017, Banco Popular was resolved after ECB indicated that the Spanish banking group with a balance sheet size of EUR 147.9bn and a net loss of 3.5bn (end of 2016) was failing or likely to fail. Hence, the Single Resolution Board (SRB) decided on a write-down of equity, additional tier 1 instruments, and a transfer of capital instruments to Banco Santander. While the failure of Banco Popular certainly cannot be considered as positive per se, we view the successful and swift resolution under the SRB framework as encouraging since potential negative repercussions on the stability of Spain's financial sector were avoided, deposit holders protected, and Spanish authorities showed the determination to adhere to and implement the recently enacted European rules of the game as regards banking recovery and resolution.

While we believe that the macroeconomic imbalances will continue to unwind, this should translate into a sustained growth momentum for the Spanish economy going forward. The scale and speed of growth have not abated yet as the first half of the year has seen very robust quarterly growth rates. After posting a quarterly expansion of 0.8% in Q1-17, GDP rose by 0.9% in the second quarter (INE flash estimate) and thus eventually surpassed its pre-crisis level of 2008. As cost competitiveness gains, the strengthening of bank and private sector balance sheets, and a further improving labor market have carried over to 2017, we forecast real GDP to expand by 3.2%. We expect the economy to slow to 2.6% next year and remain robust at an average of approx. 2% in 2019-21 as external tailwinds should gradually subside. However, there is some upside to our projection as Spain's macro performance has consistently outperformed our forecasts.

Buoyant sentiment indicators signal that GDP growth should mainly be supported by brisk consumption and investment growth. Private consumption spending should be boosted by further employment growth, as quarterly data indicates that the strong momentum on the labor market is set to remain in place. Thanks to reform efforts, the recent growth performance and modest wage growth, employment growth has not slowed down yet, as the employment rate rose to 60.4% in Q1-17 (Q1-16: 59.1%). In the second quarter, the number of unemployed Spaniards edged below the mark of 4 million (3.93m; Q2-16: 4.59m). Still, its growth contribution is likely to moderate somewhat, as we expect private consumption spending to be constrained by rising consumer prices and the positive impact of recent tax cuts to slacken. Investment activity is likely to remain vivid, bolstered by

favorable financing conditions, a lower debt burden, the housing recovery and strong exports. At the same time, somewhat weaker domestic demand should be offset by a rising growth contribution of net exports backed by strong export growth, which we believe to benefit from the brighter outlook for global trade in general, gains in cost competitiveness, and strong tourist inflows.

In the medium term, reform efforts are essential to warrant a continued adjustment of macroeconomic imbalances and to maintain the growth momentum. High unemployment, structural and regulatory barriers, and a still recovering financial sector are likely to weigh on medium-term prospects for the Spanish economy. Last year, the authorities stepped up reform efforts to support young workers on the labor market. While vocational education was strengthened, an additional reform was agreed in December 2016 according to which young workers will automatically receive support from the Youth Guarantee if they are registered as unemployed. What is more, financial assistance to the long-term unemployed was ramped up by means of a new joint action plan. Concerning regulatory barriers, product market regulation has been improved somewhat and implementation of the Market Unity Law of 2013 has advanced. The number of cases solved doubled in 2016 (to 82 cases) and by mid-2017, already 42 solved cases could be registered – as many as in 2015 on the whole.

By and large, however, reform progress slowed significantly in 2016 as the formation of a new government proved to be very difficult. National elections were held twice (December 2015, June 2016), but did not yield a clear majority. Eventually, Spain ended ten months of political gridlock and former PM Rajoy (PP) was re-elected in October 2016, forming a minority government. While this is not Spain's first minority government, higher parliamentary fragmentation may hamper the reform process. To be sure, we continue to expect that reform measures will not be rolled back; however, we believe that the minority government is likely to face difficulties in implementing substantial reforms going forward and to engage in enacting incremental policy measures as incoherent ideologies appear to be more prevalent than in the past.

Very high government and external debt remain the sovereign's key credit weaknesses. In 2015-16, general government debt stabilized at a very high level, decreasing slightly from 99.8 to 99.4% of GDP. In nominal terms, however, government debt has been consistently rising, reaching EUR 1,107bn in 2016, up from the previous year's 1,074bn – due to the large, albeit decreasing, deficits. That said, the government has continued to make progress in fiscal consolidation and met its deficit target for 2016, as the headline deficit came in at 4.5% of GDP. Having fallen from 5.1% of GDP in 2015, consolidation was mainly due to declining general government expenditure (-1.4 p.p. GDP). Revenue growth was healthy, but moderate – general government revenues increased by only 1.5% to EUR 422bn. Revenue-to-GDP thus fell to 37.9% of GDP, well below the euro area average of 46.2% of GDP. The autonomous regions accounted for the bulk of the deficit reduction as the regional government's headline deficit fell from 1.7 to 0.8% of GDP, though they fell short of the 2016 deficit target (0.7%). On the downside, pressure on social security appears to mount as its balance deteriorated from -1.2 to -1.6% of GDP.

Since the second half of 2016 the authorities have adopted a range of measures aiming at broadening the tax base, thereby increasing revenue. The rate on corporate income tax (CIT) prepayments was increased by Royal Decree Law 2/2016 (30-Sep-16), which also introduced a new mandatory minimum CIT prepayment. Royal Decree Law 3/2016 (02-Dec-16) eliminates the deduction of losses of investments in other companies, modifies the reversal of impairment values, and places limits and defers the use of net operating losses and double taxation credits. Moreover, RDL 3/2016 increases the rates for excise taxes on intermediate products, spirits and alcoholic beverages, and on tobacco products. Additionally, Royal Decree 596/2016 (02-Dec-16) establishes a new electronic system for keeping VAT register books.

Going forward, we assume that the government will succeed in bringing the headline balance below -3% of GDP by 2018. We forecast the deficit to narrow to 3.1% this year and 2.5% of GDP in the upcoming year. Benign economic prospects are likely to result in higher tax revenues and lower unemployment and social security benefits, while interest expenditure should decrease. Nevertheless, there appear to be risks to the budget, as Spain exhibits a track record of missed targets and relatively weak fiscal compliance at the regional level which has somewhat impeded fiscal consolidation over the recent years. Thus, AiReF deems the achievement of the 2017 stability target at the level of the autonomous regions to be likely on the whole, with 12 of the 17 regions likely meeting their targets. Furthermore, the independent fiscal council considers it highly unlikely that the central government will reach its 2017 target. Also, the authorities already reckon with possible additional costs arising from the assistance to financial institutions and toll roads subject to bankruptcy proceedings.

Short-term fiscal sustainability risks appear to have diminished as the minority government showed its ability to act in July 2017. The parliament has approved the 2018-20 budget stability and public debt targets as well as the spending ceiling for 2018 which limits state non-financial spending to EUR 119.83bn, 1.3% above the spending limit for 2017 – thus we see a good chance of an agreement on the 2018 budget. As regards the medium to long term, fiscal sustainability risks stemming from age-related spending should be limited, mainly due to the pension reforms of 2011 and 2013. Concurrently, contingent liabilities fell from 9.6 to 7.8% of GDP in 2015-16. The outstanding amount of the ESM loan was EUR 33.7bn as of mid-2017. As judged by the EU Commission, the repayment risk for the loan is very low. Notably, the sovereign has made five voluntary early repayments and has envisaged another one for November 2017.

Over the next few years, we believe that general government debt is set to stay high but to gradually decline on the back of the economic recovery, an improving primary balance, and lower interest expenditure. The sovereign continues to benefit from the low interest rate environment as it alleviates the debt servicing burden. Thus, interest rate expenditure has fallen to 7.4% of general government revenue, down from 8.0% in 2015 (2014: 9.0%). Spain displays a well-balanced debt distribution, with gross financing needs gradually decreasing, and has a diversified investor base in terms of type of investor and geographical distribution. What is more, the average life of debt outstanding increased from 6.81 to 7.03y in 2015-16 (2013: 6.2y).



On the external side, Spain is still heavily indebted towards the rest of the world. To be sure, last year saw a further strengthening of Spain's external position as repeated current account surpluses began to result in an improvement in its net international investment position (NIIP). The current account rose from 1.4% of GDP in 2015 to 2.0% of GDP in 2016, the fourth consecutive current account surplus. While lower energy prices and interest rates were also at play, the increase was largely driven by the strong performance of exports of goods and services which were buttressed by higher cost competitiveness and a broader export base. In particular, the trade in goods balance has continued to improve, posting at -1.6% of GDP in 2016, up from -2.0% of GDP a year before (2007-12 average: -5.3% of GDP). The trade in services surplus held up well, standing at 4.5% of GDP (2013-16 average: 4.6% of GDP). Thus, net external liabilities edged up to -85.7% of GDP, after posting at -91.3% and -97.5% of GDP in 2015 and 2014, respectively. Still, Spain exhibits one of the most negative NIIPs in the world, implying a high vulnerability to adverse market developments, and we believe that an extended period of time is required to bring the NIIP up to more sustainable levels. Based on our assumption that the growth momentum should be sustained over the medium term and the current account surplus is likely to remain in place, we expect Spain's negative NIIP to decline over the next few years. The EU Commission estimates that the NIIP could reach a level of approx. -50% of GDP by 2025 if GDP growth was to average at around 2% of GDP and the current account stabilized at the current level.

## Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating of BBB+ is positive, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – is likely to improve over the next 12-24 months.

We could raise Spain's rating if public finances continued to improve and a sustained reduction in the headline deficit was achieved. Other factors which may result in an upgrade include a continuation of the economic recovery and a sustained growth momentum, as well as a further adjustment of macro-financial imbalances. In this regard, re-establishing the reform momentum to address regulatory and structural bottlenecks, thereby preserving and enhancing recent competitiveness gains, may also translate into an upgrade.

We could revise our outlook to stable if economic performance disappointed and medium-term GDP growth significantly decelerated, if we observe fiscal slippages and non-compliance with the announced fiscal targets for 2017-18, thus bringing general government debt on an upward trajectory, or if the current account entered negative territory again.

If, contrary to our belief, Catalonia separated from the Spanish state, this would entail substantial adverse effects on Spain's sovereign credit rating. Despite the lack of consent from the Spanish central government, the regional premier of Catalonia called an independence referendum for 01 October 2017. There is an increased likelihood that the ref-

erendum will be annulled by Spain's Constitutional Court. Our baseline scenario involves a continuation of the struggle for more autonomy between the Catalan government and Madrid, without reaching a satisfactory agreement for both parties.

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## Ratings\*

Long-term sovereign rating	BBB+ /positive
Foreign currency senior unsecured long-term debt	BBB+ /positive
Local currency senior unsecured long-term debt	BBB+ /positive

\*) Unsolicited

## Economic Data

[in %, otherwise indicated]	2011	2012	2013	2014	2015	2016	2017 <sup>e</sup>
Real GDP growth	-1.0	-2.9	-1.7	1.4	3.2	3.2	3.2
GDP per capita (PPP, USD)	32,467	32,075	32,156	33,282	34,751	36,416	38,239
Inflation rate, y-o-y change	3.0	2.4	1.5	-0.2	-0.6	-0.3	2.0
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	82.5	82.4	83.1	83.2	83.4	n.a.	n.a.
Fiscal balance/GDP	-9.6	-10.5	-7.0	-6.0	-5.1	-4.5	-3.1
Current account balance/GDP	-3.2	-0.2	1.5	1.1	1.4	2.0	n.a.
External debt/GDP	151.8	129.3	166.0	153.2	165.3	159.5	n.a.

Source: International Monetary Fund, World Bank, Eurostat, own estimates

## Appendix

### Regulatory Requirements

This sovereign rating is an unsolicited credit rating. Neither the rated sovereign nor a related third party participated in the credit rating process. Creditreform Rating AG (CRAG) had no access to the



accounts, representatives or other relevant internal documents for the rated entity or a related third party.

The rating was conducted on the basis of CRAG's "Sovereign Ratings" methodology. CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG's rating methodologies is published on the following internet page: [www.creditreform-rating.de](http://www.creditreform-rating.de).

To prepare this credit rating, CRAG has used following substantially material sources: International Monetary Fund, World Bank, Organisation for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, Tesoro Publico de Espana, Banco de Espana, Instituto Nacional de Estadistica.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with and that the rating action was and is free of any existing or potential conflicts of interest. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG's "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

In the case of a rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report.

There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In regard to the rated entity CRAG regarded available historical data as sufficient.

In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

In accordance to Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: <https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml>.

An explanatory statement of the meaning of CRAG's default rates are available in the credit rating methodologies disclosed on the website.

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