FitchRatings

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Fitch On:

The Middle East

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ABOUT FITCH ON: THE MIDDLE EAST

Fitch On: The Middle East is a curated compilation of Fitch Ratings' in-depth research and commentary. This edition takes a deep dive into the macroeconomic outlook for the Middle East region, as well as sector-specific looks at Banks, Corporates, Sovereigns and Islamic Finance.

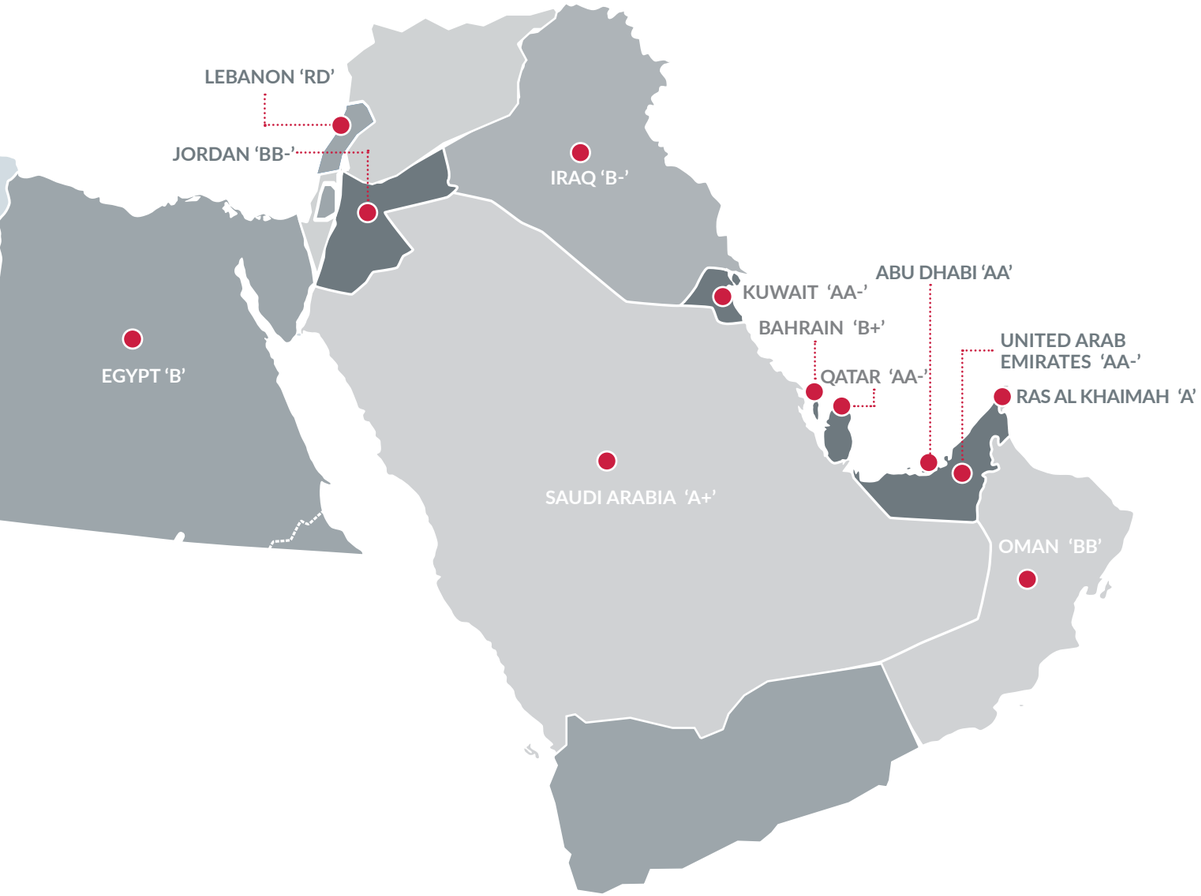
Fitch has been covering the Middle East since 1995, and opened a branch in the Dubai International Financial Center in 2006. Fitch is currently the only credit rating agency with locally registered and onshore licensed operations in both the United Arab Emirates and in the Kingdom of Saudi Arabia.

Through greater transparency, our credit ratings help support the development of local capital markets. For example, Fitch introduced a National Rating Scale for Saudi Arabia in 2020, which has helped support the large, evolving domestic currency market.

At Fitch, our seasoned team of analysts collaborate across sectors to provide global, integrated analysis and commentary. We hope this issue serves as a valued resource to help you make more informed investment decisions. We welcome comments, including suggestions for topical or credit-specific research for future issues.

For our latest insights on the region, please visit our **Middle East page**, or subscribe to our monthly **Middle East newsletter.**

MIDDLE EAST MAP



- 160 Fitch-rated issuers in 10 Middle Eastern countries across a diverse range of sectors
- Solicited ratings coverage on all regional sovereigns
- Leading market share in infrastructure and project finance, banks and public finance ratings. Fitch covers more Islamic finance-based issuers than any other international credit rating agency
- In the public sector, Fitch rates all rated issuers in the Middle East including some of the largest sovereign wealth funds

SOVEREIGNS

MIDDLE EASTERN COUNTRIES CONTINUE TO TARGET HIGHER RENEWABLE ENERGY CAPACITY

– May 11, 2023

Middle Eastern countries are accelerating the deployment of renewable energy as they continue to decarbonise their power sectors.

Rapid economic and population growth has contributed to the rise in energy consumption in the Middle East. As many of these countries are rich in oil or gas, most have historically focused on fossil fuel-based power generation. However, in recent years, many countries in the region have implemented plans to increase the share of renewable energy in their power mixes. UAE targets 44% renewable energy by 2050, while Saudi Arabia is aiming for 50% by 2030.

The total installed capacity of solar energy in Saudi Arabia was 440MW in 2022, compared to just 22MW in 2013, while Egypt's total installed capacity for wind energy rose to 1,643MW from 555MW, according to the International Renewable Energy Agency. However, the share of renewable energy in the energy mix in the Middle East remains lower than in other regions. While a lot of the renewable energy capacity is expected to come from solar energy due to very favourable irradiation resources, the region also benefits from good wind resources. For example, ACWA Power has plans to build a 1.1GW wind power plant in Egypt by 2026.

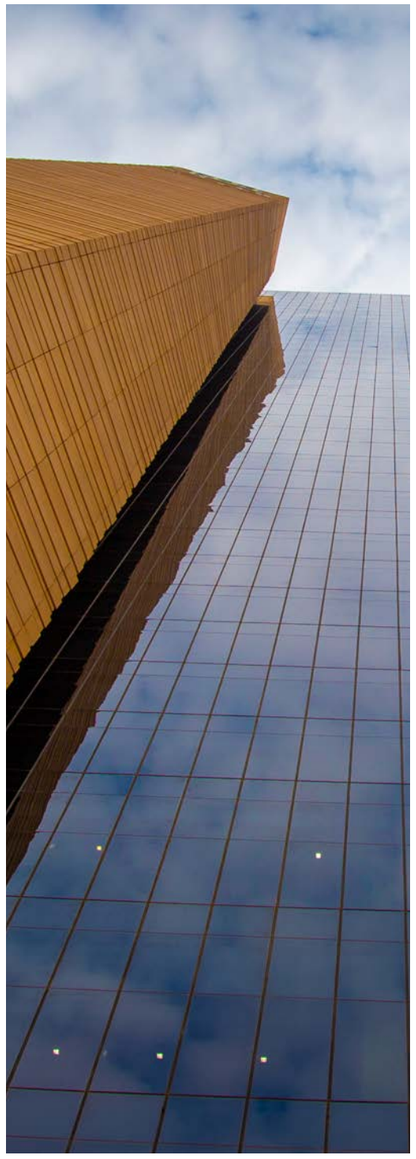
In light of the Russia-Ukraine war, European countries have begun to develop measures to improve energy security and significantly reduce dependence on Russian fossil fuels. This will be achieved partly by accelerating the roll-out of renewable energy generation within Europe, but also by European governments finding alternative energy suppliers outside of Russia. For instance, the GREGY Interconnection Project is expected to see renewable energy exported from Egypt to Greece via a 3,000MW capacity 950km underwater cable. The project is being developed by ELICA S.A., a subsidiary of Copelouzos Group. We believe that other Middle Eastern-EU partnerships may arise in the near term.

Recent solar auctions in the Middle East have achieved low awarded bid prices through competitions to appoint Independent Power Producers (IPPs), the most commonly used procurement model for energy projects in the Gulf Cooperation Council. The Mohammed bin Rashid Al Maktoum Solar Park in the UAE, with its first phase commissioned in 2013, is one of the world's largest single-site solar parks and is based on the IPP model. Its capacity is expected to reach 5GW by 2030. More recently in 2021, a Saudi Arabian tender under the National Renewable Energy Program saw the Al Faisaliah (Shuaibah) Solar PV IPP project (600MW) being awarded to provide power at a reported levelised cost of energy of 1.04 US cents/kWh.

Many utility-scale renewable projects in the region are procured with a government-related entity (GRE), such as Emirates Water and Electricity Company, Dubai Electricity and Water Authority, or Qatar General Electricity and Water Corporation, as an off-taker. The off-taker rating typically caps the project rating under Fitch's Renewable Energy Project Rating Criteria. Fitch may include some rating uplift if the off-taker is a GRE and the project is deemed to be of strategic importance and as such likely to receive government support if needed.

Given that sovereign ratings in Middle Eastern countries vary significantly from 'AA-'/Stable for Kuwait and the UAE to 'B-'/Stable for Iraq, this is likely to influence the attractiveness of projects to creditors and could lead to differential rates of capacity deployment.

SOVEREIGNS



SOVEREIGN CONTINGENT LIABILITIES IN THE GCC – March 6, 2023

Government-related entity debt as a share of GDP across the Gulf Cooperation Council may continue rising after 2022 as these entities help drive national economic agendas aimed at job creation, diversification and energy transition. High interest rates and the global economic slowdown could weigh on the financial profiles of some GREs. Asset sales and listings will continue, led by Dubai and Oman, reducing pressure to leverage.

The debt in 2021 was higher than before the pandemic, despite the economic recovery and rebound in oil prices and production. Aggregate GCC non-bank GRE debt rose to 31% of GDP in 2021, from 30% in 2019, although down from 37% in 2020 when the GDP shock led to a rise in the ratio. Non-bank GRE debt increased by over 10% of GDP in Oman and Bahrain and 6% in Qatar. Aggregate GCC bank GRE debt (wholesale or interbank funding, excluding customer deposits) rose to 22% of GDP in 2021 from 18% in 2019. Although Banking System Indicators (BSI) are well below sovereign ratings in most countries, contingent liability risks from banking sectors are low.

High interest rates and the global economic slowdown could weigh on the financial profiles of some GREs. Asset sales and listings will continue, led by Dubai and Oman, reducing pressure to leverage.

FITCH DOWNGRADES EGYPT TO 'B'; OUTLOOK NEGATIVE – May 5, 2023

Fitch Ratings has downgraded Egypt's Long-Term Foreign-Currency (LTFC) Issuer Default Rating (IDR) to 'B' from 'B+'. The Outlook is Negative.

In Fitch's view, external financing risk has increased given high external financing requirements, constrained external financing conditions and the sensitivity of Egypt's broader financing plan to investor sentiment. All this comes against a background of high uncertainty on the exchange-rate trajectory, and reduced external liquidity buffers.

We see a risk that a further delayed transition to a flexible exchange rate will further undermine confidence, and, potentially, delay the IMF programme. The rating action also captures a marked deterioration of public debt metrics, including a renewed deterioration in government interest costs/revenue, which, if not reversed, would put medium-term debt sustainability at risk.

FITCH UPGRADES SAUDI ARABIA TO 'A+'; OUTLOOK STABLE – April 5, 2023

Fitch Ratings has upgraded Saudi Arabia's Long-Term Foreign-Currency Issuer Default Rating to 'A+' from 'A'. The Outlook is Stable.

The upgrade of Saudi Arabia's ratings reflects its strong fiscal and external balance sheets, with government debt/GDP and sovereign net foreign assets (SNFA) considerably stronger than both the 'A' and 'AA' medians, and significant fiscal buffers in the form of deposits and other public sector assets. The upgrade also assumes ongoing commitment to gradual progress with fiscal, economic and governance reforms. Oil dependence, weak World Bank governance indicators and vulnerability to geopolitical shocks remain relative weaknesses, although there are some indications of improvement in these factors.

Foreign reserves excluding gold remained broadly stable in 2022, at USD459 billion, as financial account outflows in the form of investments and deposits abroad offset the substantial current account surplus (13.6% of GDP; USD150 billion). Saudi Arabia has one of the highest reserve coverage ratios among Fitch-rated sovereigns at 18 months of current external payments. We forecast reserves will decline marginally to USD445 billion in 2023-2024, as the current account surplus falls to close to 7.5% of GDP in 2023 and 4% in 2024 due to lower oil revenue, but outward investments by large institutions such as the Public Investment Fund (PIF) and pension funds should moderate this impact.

We forecast SNFA will remain above 55% of GDP in 2023-2024, large relative to the 'A' median (3.1% of GDP) and the 'AA' median (33% of GDP), although substantially lower than regional peers in the 'AA' rating category. SNFA include central bank foreign reserves as well as the foreign assets of pension funds and the PIF, minus the foreign liabilities of the government, central bank and the PIF.

FITCH REVISES OUTLOOK ON OMAN TO POSITIVE; AFFIRMS AT 'BB' - April 11, 2023

Fitch Ratings has revised the Outlook on Oman's Long-Term Foreign-Currency Issuer Default Rating to Positive, from Stable, and has affirmed the rating at 'BB'.

The Positive Outlook reflects lower government debt/GDP, with high oil prices and spending restraint reducing external liquidity risk. The Outlook also incorporates our expectation that the government will remain committed to fiscal consolidation. Fiscal reform should be sufficient to limit a deterioration of Oman's budget, debt/GDP ratio and external position under our assumption of lower oil prices this year and next. Government debt/GDP fell to 40% in 2022, from 61% at end-2021, and we expect it to reach 37% by end-2024, from 48% at our last review in August 2022.

We project a government budget surplus of 2.3% of GDP in 2023, against 4.9% in 2022, Oman's first surplus since 2013. We assume the average Brent oil price will fall to USD85 a barrel in 2023, while production will be limited by OPEC+ production caps agreed in April 2023, leading to a 9% drop in total revenue. This is despite higher tax revenue on stronger tax enforcement and economic activity. Our fiscal balance metric differs from the government, as we exclude some dividends, liquidity and debt management items from revenue and spending.

We forecast a budget surplus of 0.1% of GDP in 2024, as a small rise in oil production is likely to be insufficient to counter the effect of lower oil prices of USD75/barrel Brent on budget revenue. Non-oil tax revenue should rise to 5.6% of non-oil GDP, from 5.2% in 2022; a modest increase as we do not factor in a mooted value added tax (VAT) hike at this stage.

FITCH REVISES QATAR'S OUTLOOK TO POSITIVE; AFFIRMS AT 'AA-' – March 28, 2023

Fitch Ratings has revised the Outlook on Qatar's Long-Term Foreign-Currency Issuer Default Rating to Positive from Stable and affirmed the IDR at 'AA-'.

The revision of the Outlook reflects Fitch's expectation that debt to GDP will remain in line with or below the 'AA' peer median, while Qatar's external balance sheet will strengthen from an already strong level. The additional LNG export capacity that will be brought online as a result of the North Field expansion will bring down Qatar's already low fiscal breakeven hydrocarbon price.

Qatar's 'AA-' ratings are supported by large sovereign net foreign assets, one of the world's highest ratios of GDP per capita and a flexible public finance structure. Rating weaknesses include higher government debt/GDP than oil-dependent highly-rated peers and substantial contingent liabilities, heavy hydrocarbon dependence and below average scores on some measures of governance.

BANKS

UAE ISLAMIC BANKS SUPPORTED BY FAVOURABLE OPERATING CONDITIONS – May 18, 2023

High oil prices and solid economic conditions will continue to support UAE Islamic banks' credit fundamentals in 2023, limiting the impact of rising profit rates on borrowers. Continued digitalisation will enhance the need for further M&A to defend market share and find cost synergies, particularly among smaller Islamic banks that risk being left behind.

The UAE remains a key Islamic finance hub as Islamic financing growth outpaces that of conventional banks in 2022 due to continued rising public demand for Islamic products and deep distribution networks. At end-2022, Islamic financing accounted for 29% of total sector financing.

The UAE government's launch of a dirham-denominated Islamic Treasury Sukuk in May is an important step in the development of the nascent domestic debt capital market. It gives all banks more options to invest their liquidity and should help build the domestic yield curve. Earlier this year, Emirates Islamic Bank issued the first UAE-Dirham sukuk.

Since 2022, it has been mandatory for Islamic banks to maintain profit equalisation and investment risk reserves, which we view as credit positive. However, Fitch still believes that the enforcement of principle losses on profit-sharing investment accounts in the UAE is unlikely, and that these developments are broadly ratings neutral. We continue to assess potential credit implications.

SAUDI BANKS TO PERFORM WELL IN 2023 DESPITE TIGHTER LIQUIDITY– July 17, 2023

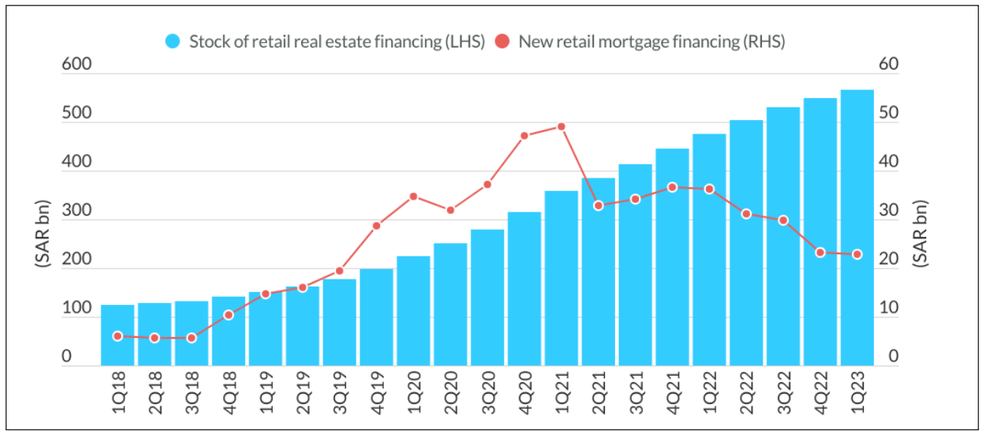
Saudi banks' performance metrics should remain healthy in 2023 despite tighter liquidity, as the favourable operating environment will continue to benefit profitability metrics.

The average operating profit/risk-weighted assets of Fitch-rated Saudi banks was 2.7% in 2022, and we expect non-oil economic growth to support profitability in 2023, driven by government capex, private-sector credit growth, lower unemployment and the government's ongoing Vision 2030 strategy.

We expect average sector financing growth to slow to about 12% in 2023 (2022: 14%), but to remain above the GCC average (2023F: 5%–6%). Strong demand for mortgage financing, underpinned by a state subsidy programme, has supported financing growth in recent years. Mortgage financing reached SAR567 billion at end-1Q23, with a compound average growth rate of 35% over the past five years.

New quarterly mortgage issuance peaked at SAR49 billion in 1Q21, but has since fallen (1Q23: SAR23 billion) due to rising interest rates and market saturation. We expect further declines in 2023 and 2024 due to the reduction in state subsidies for mortgages.

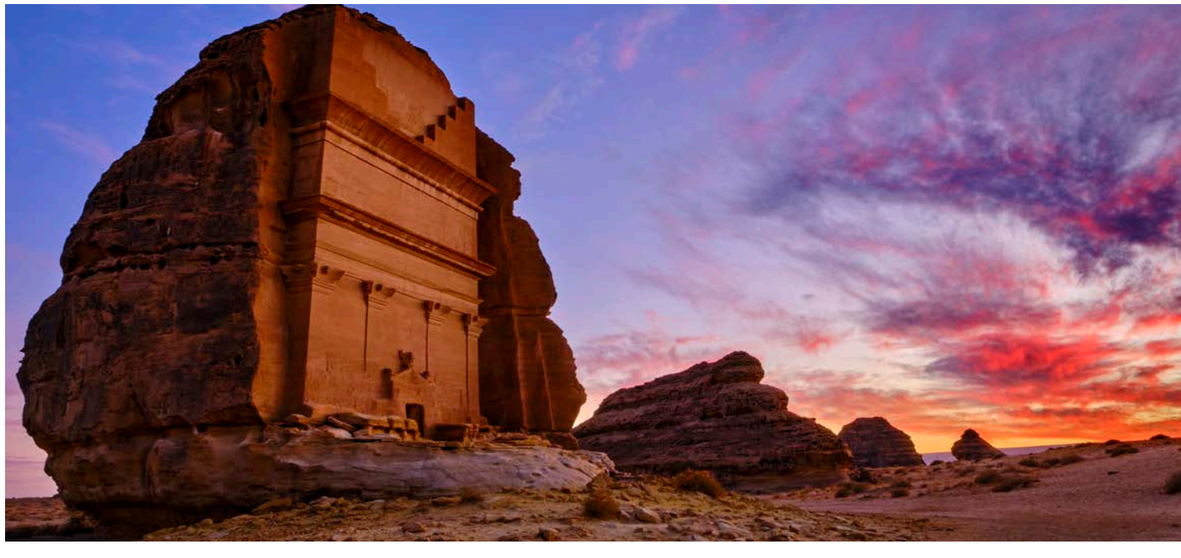
Retail Real Estate Financing, New Retail Mortgage Financing



Source: Fitch Ratings, SAMA

Liquidity tightened moderately in 2022 as sector financing growth (14%) exceeded deposit growth (9%), and rising interest rates led some customers to shift low-cost current account and savings account (CASA) deposits into term deposits. Sector CASA deposits accounted for 56% of total deposits at end-1Q23, down from 65% at end-2020.

Tighter liquidity pushed up the average cost of funding for Fitch-rated Saudi banks to 110bp in 2022 (2021: 40bp). However, Fitch expects the Saudi authorities to continue deploying liquidity into the system, when needed, to support financing growth, as the supply of credit is key to the execution of Vision 2030.



OMANI BANK PROFITS TO BE SUPPORTED BY REASONABLE FUNDAMENTALS, BETTER CREDIT CONDITIONS – May 25, 2023

Omani banks' reasonable credit fundamentals and improved operating conditions will support lending growth and profitability in 2023.

Omani banks emerged from the pandemic with reasonable credit fundamentals which place the sector in a good position for improving profitability in 2023. High oil revenues will continue to support economic activity and drive business generation for banks. Fitch expects credit growth of 4% in 2023, underpinned by high oil prices, healthy economic growth, a low inflationary environment and positive employment prospects.

Fitch revised the outlook on Omani banks' operating environment factor score to positive from stable in May 2023 to reflect improved operating conditions, as well as the revision of the Outlook on the sovereign rating to Positive from Stable. Omani banks are highly exposed to the sovereign through lending to government and government-related entities (GREs), holdings of Omani government securities, and high reliance on government and GRE deposits. Exposure to the sovereign also considers banks' exposures to public-sector employees through their retail loan books.

We continue to expect contingent asset quality risks in 2023. These could arise from the high stock of restructured loans (11% of sector loans at end-2022) and high exposure to vulnerable sectors, particularly real-estate and construction (end-3Q22: 26% of sector loans). However, banks' pre-impairment profitability provides them with reasonable buffers to absorb shocks through the income statement without hitting capital. Overall, we believe any asset quality deterioration will be contained and manageable at banks' current rating levels.

CORPORATES

OPEC+ OUTPUT CUTS TO SUPPORT SHORT-TERM PRICES, MAY PUSH MARKET INTO DEFICIT
– April 4, 2023

OPEC+ members' decision to cut production by almost 1.2 million barrels per day (MMbpd) from May until end-2023 should support prices in the short term, increasing chances that the market could switch into deficit in 2H23, particularly due to recovering consumption in China.

We believe that the market was in a moderate surplus in 1Q23 with OECD commercial inventories increasing by 32 million tonnes in January and a further 10 million tonnes in February. The decision on production cuts increases the likelihood of the market switching into deficit this year as demand will increase by 2MMbpd in 2023, according to the US EIA's estimates, mostly because of China reopening, which will account for about half of demand growth.

Greater demand will be only partially offset by higher production in North and South America, which could add a total of 1.7MMbpd, according to the IEA. While Russia may struggle to increase production because of the sanctions, Saudi Arabia, the UAE and Kuwait can fairly quickly adjust their supplies. In 1Q23, spare capacity in the Middle East was estimated at 3.25MMbpd, according to the US EIA, which will increase to almost 4.5MMbpd following the announced cuts.

Fitch assumes Brent prices to average USD85/bbl in 2023, reducing thereafter. The latest decision does not have any immediate impact on our price assumptions. However, we believe there is now a greater upside to our oil short-term price assumption.

Saudi Aramco (A/Positive), Saudi Arabia's only oil producer, will reduce its upstream oil volumes by about 5% as a result of the decision. However, the company's revenue will benefit from higher oil prices. Saudi Aramco has a very conservative financial profile with a net cash position and enjoys a very strong liquidity position with substantial cash balances and strong cash flows. The decision is credit neutral for Saudi Aramco and has no impact on our assessment of its Standalone Credit Profile of 'aa+'.

GCC GRES' ROBUST PERFORMANCE BACKED BY STRONG GOVERNMENT LINKS – March 7, 2023

The links between Fitch-rated corporate government-related entities in the Gulf Cooperation Council and their respective states remain strong. Entities with economically critical roles have high importance and are strongly tied to their respective governments. We, therefore, do not expect any material dilution of these links.

Improving economic growth and strong market fundamentals have supported entities' Standalone Credit Profiles. Nearly 50% of SCPs are capped by their respective entities' Issuer Default Ratings, reflecting stable underlying performances at an entity level. Needs for tangible support have diminished, but Fitch expects government support for GCC GREs to reinforce their ability to withstand financial distress.

We expect GREs to play an increasing role in the private sector in 2023 as key contributors to economic activities and private sector job creation. They remain primary beneficiaries of state spending. Major GCC economies are focusing on investments in energy capacity and energy transition, as well as non-hydrocarbon sectors to limit budget volatilities to oil prices.

FITCH RATINGS CUTS NEAR-TERM OIL AND GAS PRICES, RAISES MID-CYCLE OIL ASSUMPTIONS

– June 21, 2023

Fitch Ratings has cut its oil and gas price assumptions for 2023 and the 2024 European TTF gas price, reflecting weaker demand and robust supply in the near term. We have increased our 2025-2026 and mid-cycle oil assumptions due to expectations of gradually increasing demand, at least in the next five to seven years, which will eventually be met by rising production in OPEC+ countries, North America and potentially some other regions.

Oil and Gas Price Assumptions

	2022	2023		2024		2025		2026		Long-term	
	Actual	Old	New	Old	New	Old	New	Old	New	Old	New
Base Case											
Brent (USD/bbl)	99.0	85.0	**85.0**	65.0	**75.0**	53.0	**65.0**	53.0	**53.0**	53.0	**53.0**
WTI (USD/bbl)	94.3	81.0	**80.0**	62.0	**70.0**	50.0	**60.0**	50.0	**50.0**	50.0	**50.0**
Henry Hub (USD/mcf)	6.4	5.0	**3.5**	4.0	**3.5**	3.0	**3.0**	2.75	**2.75**	2.75	**2.75**
TTF (USD/mcf)	15.8	40.0	**20.0**	20.0	**20.0**	10.0	**10.0**	5.0	**5.0**	5.0	**5.0**
Stress Case											
Brent (USD/bbl)		45.0	**70.0**	35.0	**45.0**	45.0	**35.0**	48.0	**45.0**	48.0	**48.0**
WTI (USD/bbl)		42.0	**65.0**	32.0	**42.0**	42.0	**32.0**	45.0	**42.0**	45.0	**45.0**
Henry Hub (USD/mcf)		2.5	**2.0**	2.0	**2.25**	2.25	**2.25**	2.25	**2.25**	2.25	**2.25**
TTF (USD/mcf)		15.0	**10.0**	7.0	**7.0**	4.5	**4.5**	4.5	**4.5**	4.5	**4.5**

Assumptions as of March 2023.
Bbl: barrel; mcf: thousand cubic feet; TTF: Title Transfer Facility; WTI: West Texas Intermediate.

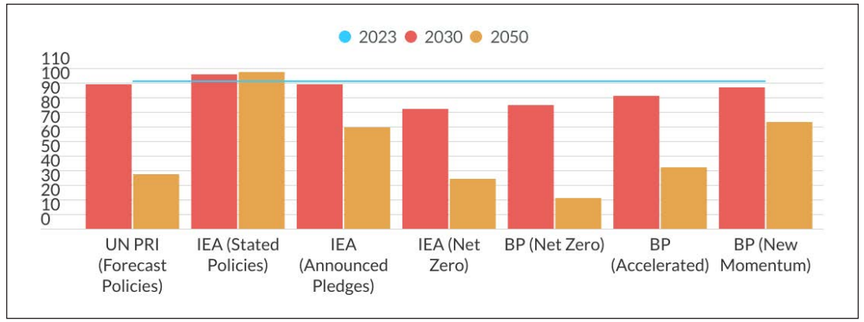
The lower assumption for 2023 oil prices reflects weaker short-term demand and concerns over slowing global economic growth and still resilient oil supplies, particularly from Russia, which redirected its exports to Asia. Although recent production cuts pledged by OPEC+ counties, particularly Saudi Arabia, offered some support to spot oil prices, their capacity will remain readily available to increase supply, when needed. The US and Canada are likely to modestly increase production in 2H23 and 2024.

The higher 2025-2026 oil price assumptions reflect our view that prices are likely to be affected by geopolitical tensions and still sound oil demand. Increased mid-cycle prices reflect a high degree of uncertainty over demand destruction associated with the energy transition and the marginal cost of supply in the sector by the end of this decade.

The use of oil in road transportation is the main source of uncertainty. The global vehicle fleet will continue to increase, driven by population growth and greater prosperity in developing countries. However, this will be offset by higher penetration of electric vehicles and traditional vehicles becoming more fuel-efficient. At the same time, the announced increases in upstream investments, including in the Middle East, will lead to greater oil production capacity. Fitch assumed that the energy transition will be gradual, with demand destruction becoming increasingly visible from the late-2020s and oil demand peaking around 2030.

Oil Demand Scenarios

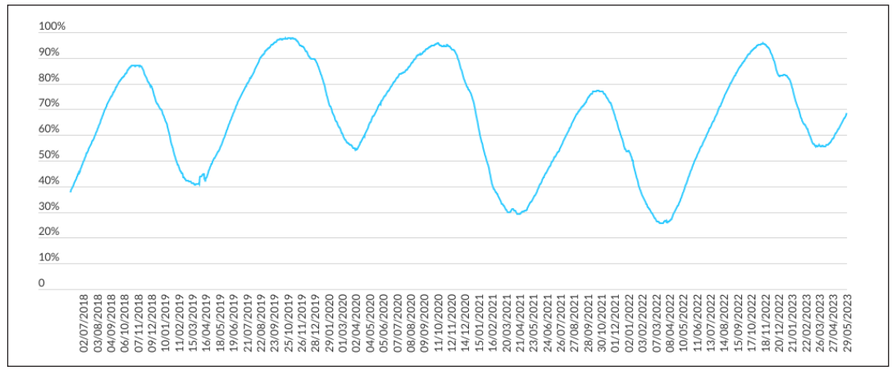
Million barrels per day



Source: Fitch Ratings, UN PRI, IEA, BP

We have reduced our 2023 and 2024 European TTF gas prices to USD12/mcf and USD10/mcf, respectively, due to ample LNG supplies to the region, curtailed demand and high storage levels (currently at 69%, well above comparable periods), leading to lower spot prices. Other TTF price assumptions remain unchanged as an increase in global LNG supply in the medium term, the build-up of LNG infrastructure in Europe and gradually improving European interconnectivity will help reduce prices to the normalised levels in a sustainable manner in the medium to long term.

EU Gas Storage Capacity Utilisation



Source: Fitch Ratings, Bloomberg

Fitch's reduced Henry Hub price assumption for 2023 reflects robust US gas production still outstripping consumption, with the rig count not declining as fast as previously expected. However, increasing US LNG export capacity and greater reliance of the European market on gas imports from the US should support prices in 2024, which we have kept unchanged.

NEUTRAL SECTOR OUTLOOK FOR GCC CORPORATES FOR 2023 – January 9, 2023

The outlook for GCC corporates is neutral for 2023, reflecting supportive economic activity and high oil prices. Oil-exporting countries have witnessed improved fiscal budgets and we expect government-sponsored projects to stimulate private-sector activity.

We see retail, homebuilders and industrials facing more challenges than others as inflation affects raw-materials prices and cost of living. National oil companies, utilities and property companies have ample liquidity buffers, supported by leverage headroom and strong EBITDA generation.

The overall sector is stable with 82% of issuers on stable outlook, while another 11% of issuers, primarily government-related entities, are on positive outlook due to sovereign linkage. We forecast a marginal increase in median leverage to 3x in 2023 from an average of 2.8x in 2021-2022, due to strong cash generation to fund capex. We expect EBITDA growth to outpace growing interest expense for Fitch-rated issuers, with interest cover averaging 6x in 2023. Key differentiating factors across sub-sectors will be refinancing risks, funding base and financial flexibility for issuers.

Companies remain generally well-funded with ample cash build-up to finance growth. However, this will put free cash flow (FCF) margins under pressure as we factor in shareholder distributions. In addition, overall visibility on corporates spending is limited by a possible shift in financial policies linked to regional macroeconomic factors. Project pipelines and government spending will determine private-sector growth in 2023. Fitch will focus on liquidity buffers and discretionary FCF amid rising debt costs and multi-tiered inflationary pressures.

ISLAMIC FINANCE

SUKUK RECOVERY IS STILL UNTESTED IN MOST ISLAMIC FINANCE MARKETS - June 14, 2023

The majority of the Organisation of Islamic Cooperation (OIC) countries covered by Fitch Ratings' updated Country-Specific Treatment of Recovery Ratings Criteria fall into the lowest level of recovery. However, sukuk recoveries given default vary between key issuing jurisdictions and remain largely untested and under-developed. There are also very few legal precedents in terms of effective enforcement in many of the jurisdictions where sukuk issuance is prevalent.

Fourteen of the 57 OIC countries are covered by the updated criteria. Countries are split into four groups (A to D), with differing caps on instrument ratings and recovery ratings (RRs) based on country-specific factors. Whilst none of the OIC countries are in Group A, over half are in Group D – the group with the lowest level of recovery.

The UAE and Qatar are the only countries among the core Islamic finance markets that are classified in the second-highest category, Group B, defined as jurisdictions where the recoveries range from superior to poor. Saudi Arabia, Bahrain, Oman and Malaysia are Group C, with recoveries ranging from good to poor. Fitch classifies the remaining eight OIC countries – Azerbaijan, Indonesia, Jordan, Kazakhstan, Morocco, Nigeria, Turkiye and Uzbekistan – in Group D, where the recoveries range from average to poor.

Bankruptcy laws have been updated over recent years in many of the countries in which Islamic finance is prevalent. However, there is little precedent as to how bankruptcy courts might treat sukuk defaults, and whether this might be different to bond defaults in such events, and if sukuk certificate holders will be able to enforce their contractual rights in local courts. English law often governs sukuk issued on the international capital markets, but some of the documents would be governed by local law from where the originator is domiciled – local courts would review the documentation as well as any judgement, which could be subject to local restrictions on enforceability.

As sukuk default resolution and recovery has few legal precedents in most key markets, the level and scope of investors' ability to exercise their contractual rights is uncertain. As of end-1Q23, only 0.24% of all issued sukuk had defaulted, with the first Fitch-rated sukuk defaulting in 2021. Additionally, in 1Q23, 78.5% of Fitch-rated outstanding sukuk were investment-grade. Sharia (Islamic rulings) has an influence on the sukuk rating process, but being rated does not necessarily imply that the sukuk are sharia-compliant.

The classification of countries is based on the assessment of each country's governance environment, leveraging three indicators reported by the Worldwide Governance Indicators project of the World Bank. Qatar and the UAE, both Group B countries under Fitch's assessment, had some of the highest rankings of the 55 covered OIC countries. The UAE recorded the highest rank (82.2) for Regulatory Quality, followed by Brunei and Qatar. Qatar scored 81.3 under the indicator Rule of Law, followed by Brunei and UAE, and Brunei ranked highest under the Control of Corruption indicator, at 86.1, followed by the UAE and Qatar.

BAHRAINI ISLAMIC BANKING PENETRATION SOLID, TO BENEFIT FROM CONSOLIDATION - March 1, 2023

Bahrain's Islamic banking market share is expected to increase to over 50% of total domestic banking sector assets in the short-to-medium term on the back of mergers and acquisitions as well as from sustained demand for Islamic products.

Rising rates should also support Islamic and conventional banking sector profitability, with reasonable liquidity and capital adequacy buffers expected to be maintained in 2023. Islamic banking has significant importance in Bahrain, comprising 38.3% of domestic banking system assets and 18.5% of total banking system assets (including foreign assets) at end-2022. Islamic banks' assets (including Islamic-banking windows available at conventional banks) increased by 7.6% in 2022 – a faster pace than conventional banks' asset growth of 2%.

A major boost to the sector will come from the acquisition of Ahli United Bank B.S.C. (AUB), a Bahrain-based conventional bank, by Kuwait Finance House K.S.C.P. (KFH), Kuwait's largest Islamic lender. KFH plans to convert AUB and its subsidiaries into fully sharia-compliant banks. AUB had a 13% market share of the Bahraini domestic banking sector assets as of end-2022, making the combined entity one of the largest domestic banks in Bahrain. The acquisition has resulted in KFH becoming the world's second-largest Islamic bank by assets. Fitch expects the sharia conversion to be completed between end-2023 and end-1Q24 based on current estimates.

Bahrain's Islamic banking market is the seventh-largest globally, with total assets of USD41.6 billion or 92.4% of Bahrain's GDP. The sector's growth is supported by a long-established financial services sector, the enabling regulations for Islamic finance, demand for Islamic products from Bahrain's Muslim-majority population, a deep distribution network, and the presence of skilled human capital.

More favourable prudential requirements are also supporting Islamic banking growth. The regulator, the Central Bank of Bahrain (CBB), grants Islamic banks a 30% "alpha-factor," which is a discount in the calculation of risk-weighted assets; conventional banks are not granted this discount. This provides a sizable uplift to Islamic banks' capital ratios, allowing Islamic banks to grow and capture market share with less capital constraint. Fitch calculates that Bahrain Islamic Bank benefits from a sizeable uplift to its capital ratios as a result.

Bahrain also has a wider availability of Islamic liquidity-management tools compared to most other countries. This includes Islamic repurchase agreements (repos), remunerative deposits with CBB, short-term and longer-term government sukuk, and interbank placements with both Islamic and conventional banks.

In 2022, Islamic retail banks' profitability and asset quality metrics improved, though they lagged the performance of conventional retail banks. The liquidity profile of Islamic banks was also adequate, albeit weaker than conventional banks. The capitalisation profiles of Islamic and conventional banks were satisfactory.

Other acquisitions completed in 2022 include Al Salam Bank-Bahrain's purchase of the consumer banking business of Ithmaar Bank. GFH Financial Group also increased its stake in GB Corp to 62.91% (2020: 50.41%). The flows were not all one way. Al Baraka Group signed agreements to exit from two of its subsidiaries: Bank Al-Tamweel Wa Al-Inma in Morocco, and Itqan Capital in Saudi Arabia.

Despite the growth, Bahrain's share of global Islamic banking assets remains small at 3.3% at end-2021, according to the Islamic Financial Services Board, mainly due to the economy's small size. However, it was higher than Indonesia's (1.9%) and Turkiye's shares (2.9%), despite the economies of both countries being more than 10 times larger than Bahrain's.

Outstanding sukuk volumes in Bahrain reached USD14.3 billion at end-2022, which represented 31.1% of all outstanding debt capital market products, from 28.5% in 2021. The takaful sector had 12% market share of total insurance sector premiums in 2020, and was higher than the share of UAE (10.2%) and Qatar (7.9%).

OMAN'S ISLAMIC BANKING SHARE TO RISE AMIDST IMPROVING DEMAND, STRUCTURE
– March 6, 2023

The Omani Islamic banking sector's market share is expected to rise steadily in 2023–2024 after reaching 16.4% of total sector assets at end-2022 (end-2021: 15.2%). Growth will be driven by sizeable public demand for Islamic products, supportive regulations, a growing branch network, and a push from conventional banks' Islamic windows. There was a structural improvement in 2022 after the Central Bank of Oman (CBO) introduced an Islamic liquidity management instrument (ILMI) in the form of a wakala money market instrument.

The wakala money market instrument allows Islamic banks and windows to place remunerative deposits with the CBO for a minimum duration of one day to a maximum of three months. The lack of ILMI has been a long-standing challenge for the Islamic banking sector. At present, there are no Islamic repos and short-term government sukuk in Oman for Islamic banks to invest their excess liquidity or Islamic alternatives to treasury bills. Regulations prevent Islamic banking entities from placing funds with conventional banks, which limits counterparty choice. The CBO plans to introduce more ILMI in phases, both for providing liquidity support to Islamic banking entities and for absorbing excess liquidity.

Omani Islamic banks' (including windows) total assets reached OMR6.4 billion (USD16.6 billion) in 2022. The financing growth of Islamic banks was 12.2% yoy, exceeding conventional banks' 3.4% growth. Islamic bank's deposit growth of 10.9% also outpaced conventional banks', which fell by 0.9%. The Islamic banking market share, based on both financing and deposits, crossed 18.5% in 2022.

Islamic windows of conventional banks are significant growth drivers, with about 40% share of sector assets as of end-3Q22, while the balance is held by full-fledged Islamic banks.

Islamic bank windows significantly benefit from their parent conventional bank in terms of use of their existing franchise and infrastructure, making them more cost efficient.

Profit-and-loss sharing financing contracts are a key feature of the Omani Islamic banking system, in the form of diminishing musharaka and wakala, which have 51.3% and 15.9% shares of total financing, respectively, at end-3Q22. Diminishing musharaka is mainly used for property financing, while wakala enables customers to access cash products, including for working-capital requirements. Wakala financing is adopted due to the regulatory ban on tawarruq products. Islamic banks also offer deposits based on profit-and-loss sharing contracts, in the form of mudaraba.

Fitch's sector outlook for the Omani banking sector is neutral for 2023. We expect real GDP to grow 2.1% in 2023 (2022: 4.7%), which will moderately support revenue and business generation for banks. Unlike in other GCC markets, higher rates only mildly benefit Omani banks' net interest or profit margins. This is because higher rates typically drive up banks' cost of deposits, while banks have limited ability to reprice assets to offset the impact.

This is due to the strong competition for good quality corporate lending as well as the interest rate cap on retail lending (40% of total sector loans). Nonetheless, funding costs will rise only modestly given the ample local-currency liquidity in the system and the high portion of funding from low-cost current and savings accounts.

Oman's Islamic banking market is the smallest in the GCC, and still faces multiple challenges, including awareness gaps in the population, growing – albeit still limited – distribution channels, and scope to expand employee expertise. Oman's bank deposits insurance scheme only covers conventional banks; however, this is likely to be addressed with the introduction of new regulation covering Islamic deposit protection. Omani Islamic banks have smaller capital bases than their conventional peers, hindering their ability to participate in large government financing projects.

A potential merger between Islamic lender Bank Nizwa and conventional peer Sohar International Bank SAOG is currently undergoing due diligence, although it is unlikely to happen in the short term. If this goes ahead, it should enhance Sohar International's Islamic presence in the local market and support financing growth.

SUKUK PIPELINE BUILDING UP DESPITE VOLATILITIES – April 12, 2023

Global sukuk issuance faces short-term uncertainties amid continued macro volatilities. However, the pipeline for 2Q23 issuance is building up. OPEC+ members' oil production cut – by almost 1.2 million barrels per day from May until end-2023 – should support short-term oil prices (2023F oil price: USD85/barrel). High oil prices will reduce new financing needs for many core oil-exporting sovereigns. However, funding diversification is sought. Malaysia, Bahrain, and a number of core oil-importing countries still have funding needs and are expected to have budget deficits in 2023.

Sukuk issuance from core markets (1Q23: USD45.3 billion) is down 18.5% qoq. "Persistent macro volatilities and uncertainties, contraction in global liquidity and investor risk appetite, and monetary tightening is affecting sukuk and bond issuance in regions where Islamic finance is active," said Bashar Al-Natoor, Global Head of Islamic Finance at Fitch. "However, Islamic investor's liquidity and investment appetite continues to be supportive of the longer-term sukuk story." New changes to sukuk documents linked to compliance with AAOIFI sharia standards are still happening.

All Fitch-rated international sukuk issued were investment-grade in 1Q23. Outstanding ESG-sukuk reached USD 25.9 billion; up 5.7% qoq.

Global banking sectors' liquidity positions will remain under the spotlight until markets regain confidence. In the GCC (excluding Saudi Arabia), the liquidity profiles of Islamic banks – which are key sukuk investors, issuers and arrangers – are generally intact. However, liquidity conditions for Saudi banks will be challenging in 2023 due to still high, but moderating, credit growth. However, SAMA is likely to inject further liquidity if credit growth outpaces deposits.

The sukuk market became more diverse despite volatilities. Air Lease Corporation issued the largest sukuk from a US-based corporate, the first UAE-Dirham sukuk was issued from a UAE bank, and the first project-finance sukuk was also issued. In addition, Egypt issued its debut sovereign sukuk.

SOLID MARKET SHARE FOR QATARI ISLAMIC BANKS; ISLAMIC LIQUIDITY MANAGEMENT TOOLS IMPROVED – June 26, 2023

Islamic banking made up 25% of total banking sector assets in Qatar at end-1Q23 (end-1Q22: 27%), making the country the fifth-largest Islamic banking market globally. Fitch expects the market share to increase overall in 2023 due to high public demand and solid retail networks. However, Islamic banks' total assets continued to shrink in 1Q23 (-3%) due to government repayments – a similar trend to in 2022 (-5%).

Fitch expects the slightly improved profitability metrics, due to lower financing impairment charges and reasonable liquidity, to continue, with less non-domestic funding than for conventional banks. Capital buffers should remain adequate for the risks. Fitch also expects risks to asset quality to remain contained, although higher rates will start to put pressure on affordability.

The Qatar central bank's launch of Treasury sukuk in 2022 is a structural improvement as it adds to domestic Islamic banks' short-term liquidity tools. The increasing availability of government sukuk and Islamic liquidity-management tools from the central bank support Islamic banks' liquidity management and investment options.

Fitch's revision of the Outlooks on three Qatari Islamic banks to Positive from Stable in April reflected a higher probability of support from the Qatari authorities.

SUKUK PRICING REMAINS SIMILAR TO BONDS IN 1H23 AMID RISING INTEREST RATES – August 2, 2023

The pricing of most sukuk and comparable bonds continued to be similar and highly correlated in 1H23, with this trend likely to persist. This is despite macro developments such as rising interest rates and volatile oil prices and complexities in sukuk structures linked to sharia compliance. Most Fitch-rated sukuk are senior unsecured obligations of the issuer and rank equally with other senior unsecured obligations, including bonds.

Fitch analysed the pricing of 38 sukuk and comparable bonds issued by the same obligors from the Gulf Cooperation Council, Indonesia and Turkiye (based on yield-to-maturity) with more than 60% being sovereign issuance. Between 2018 and 1H23, sukuk and bonds had a high pricing correlation of 0.95 (out of 1) on average and low average spreads between them. The measures are a good gauge of investors' credit risk perception for sukuk and bonds.

Fitch also noticed periods of global volatility or sukuk-specific developments where the correlation between sukuk and bond yields fell and average spreads expanded, albeit temporarily. This includes during the pandemic in 2020 where the liquidity of Islamic banks was affected for few months, and during Russia's invasion of Ukraine in 2022 and the subsequent effect on global debt capital markets.

Spread differentials could also be explained by the buy-and-hold nature of most sukuk's Islamic investors, mainly Islamic banks, with secondary-market liquidity of sukuk tending to be limited compared with bonds. There remains a dearth of sukuk and comparable bonds in the market based on payment rank, date of issuance and maturity by the same issuer and in the same currency denomination.

Fitch also analysed Pakistan's US-dollar denominated sukuk and bonds (rated CCC), although both types of instruments are not directly comparable in date of issuance and tenor. The correlation between the sukuk and bond yields was high between January 2022 and August 2023 at 0.95; however, the yield spreads have widened between the two with sukuk pricing not falling as steeply as bonds. Both are rated senior unsecured instruments by Fitch and reflect the same credit profile, with such pricing changes likely to be reflective of market dynamics.

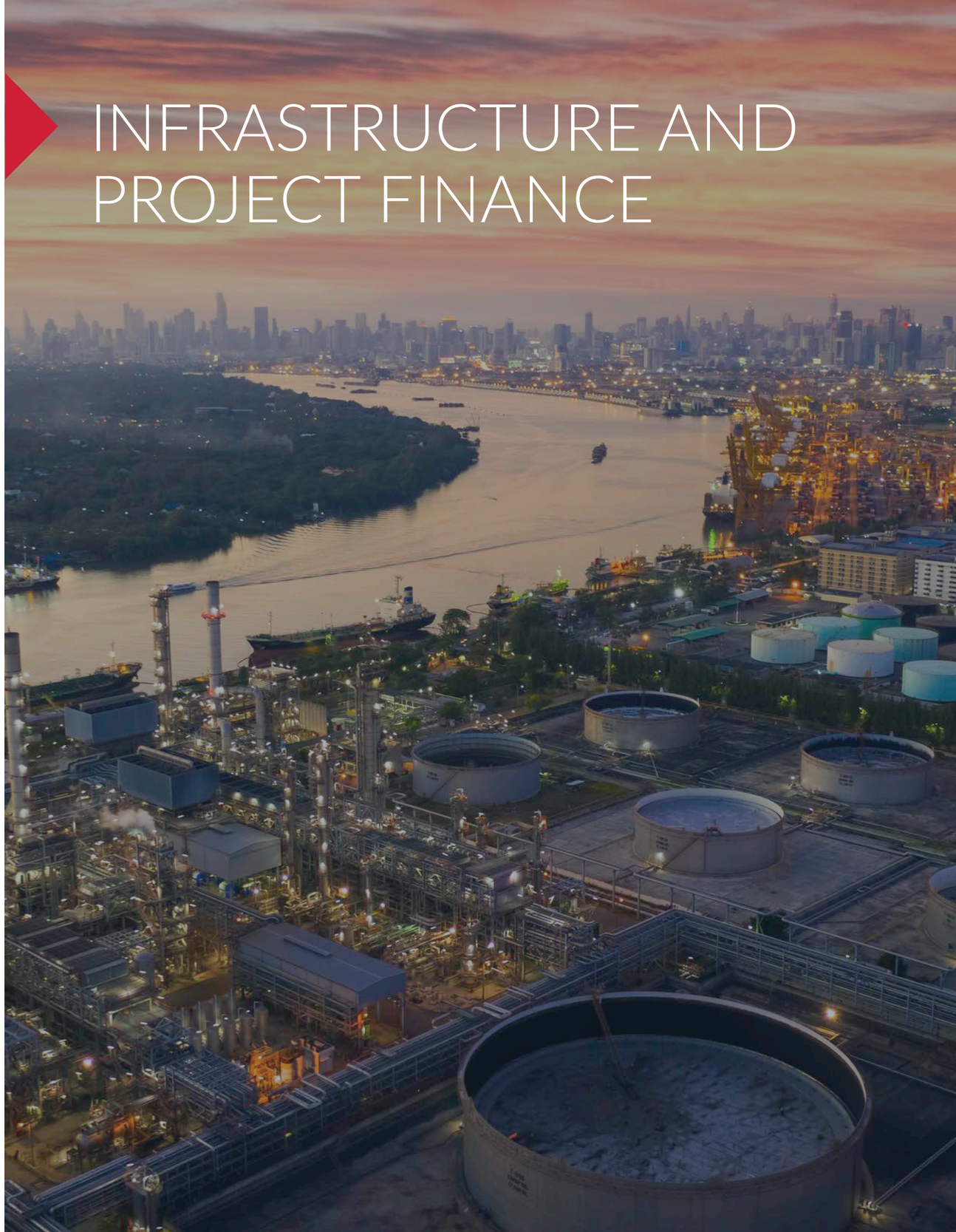
As of 1H23, a US Dollar Sukuk Market Index analysed by Fitch increased 2.7% yoy, while a broad Emerging Markets Bond Index expanded 5.8% in the same period. However, a MENA Sukuk Index analysed by Fitch was up 1.3% yoy, while MENA Bond Index was up 0.03% only.

Issuing sukuk does not always entail a pricing advantage for issuers compared with bond issuance, with pricing swinging in both directions. Nevertheless, sukuk generally have a more diverse investor pool, in key issuing markets including Islamic investors from mainly the GCC and other key Islamic finance markets.

Sukuk are also a sizable part of emerging-market debt issuance (excluding China), with its share reaching 6% in 1H23 (2022: 6.6%). Key sukuk-issuing jurisdictions of the GCC, Malaysia, Indonesia, and Turkiye are sizeable emerging markets, with their bonds and sukuk forming 20.5% of all emerging-market debt issuance (excluding China) in 1H23.

In 2Q23, sukuk issuance from the core markets of the GCC, Malaysia, Indonesia, Turkiye and Pakistan (including multi-laterals) expanded 10% qoq to USD49.1 billion, while bond issuance fell 4.8%. Global outstanding sukuk volumes expanded 10% yoy and for the first time crossed USD800 billion, with sovereigns being the key issuers. Most Fitch-rated sukuk continued to be investment-grade at 79%, with 12.6% of issuers having a Positive Outlook, and 77.5% having a Stable Outlook at 2Q23. Sukuk defaults continue to be low at only 0.21% of all issued sukuk.

INFRASTRUCTURE AND PROJECT FINANCE

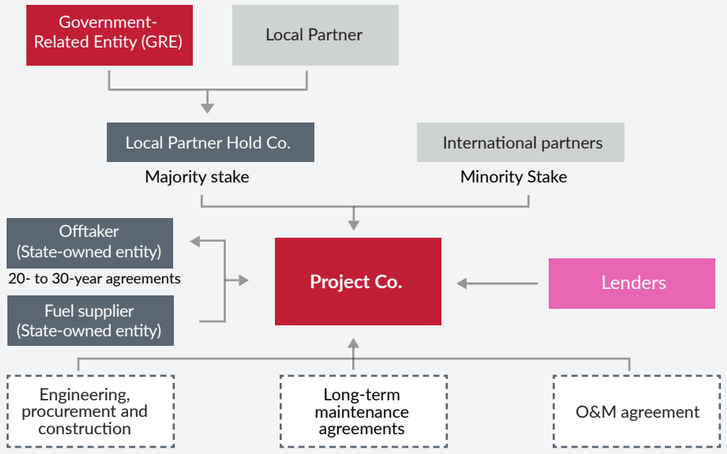


GCC POWER AND WATER PROJECT RATINGS BENEFIT FROM STATE SUPPORT – August 2, 2023

The ratings of strategically important power and water projects controlled by Gulf Cooperation Council governments or government-related entities can benefit from lower standalone risks and uplifts for extraordinary support.

GCC governments typically perform multiple roles in Fitch-rated power and water desalination projects. Project companies are usually controlled by governments or government-related entities, with minority stakes held by international investors with relevant expertise in developing, constructing and operating similar assets. Governments or GREs often act as offtakers, gas suppliers (for thermal power plants), grid operators or land lessors. This creates a stronger alignment of interests between the main project counterparties. A state-controlled tender process means that there is no or very limited competition from nearby plants.

Typical GCC Energy Project Structure



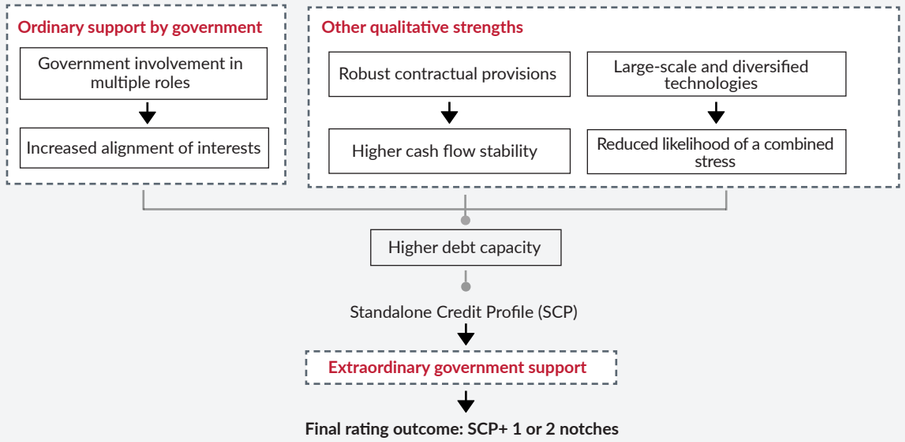
Source: Fitch Ratings

GCC power and water projects often have robust contractual provisions, such as 20- to 30-year fuel supply and offtake agreements with GREs, where prices are agreed for the duration of the contract on a "take it or leave it" basis. This greatly reduces the risks borne by projects, leading to essentially availability-based revenues, typically for the entire debt term. This supports a high degree of visibility for cash flows and financial metrics.

The projects are generally larger and often have more redundancy built into plant designs than standard power projects rated by Fitch in other regions. They also often comprise multiple technologies. Technical redundancy and multiple technologies can provide operational benefits, lowering the probability of unplanned outages or technical problems that could affect plants' performance.

The combination of these factors reduces the standalone credit risks of GCC power and water projects, leading to higher Standalone Credit Profile assessments. On the top of that, if Fitch considers a state-owned project as strategically important, where the government has extensive decision-making power and strong incentives to support the project, it could add an uplift of one or two notches to the SCP in the final rating. Support may come directly or indirectly through a GRE, but Fitch must be confident that it will be facilitated by the government and entities in the ownership chain will not hinder it. Any rating uplift is limited to two notches due to the ring-fenced nature of project finance transactions.

Specific Rating Considerations for GCC Energy and Water Projects



Source: Fitch Ratings

Most state-owned GCC power and water projects in Fitch's portfolio are based in Saudi Arabia (A+/Stable), the United Arab Emirates (AA-/Stable) and Qatar (AA-/Positive), and their ratings are, therefore, supported by strong governments' credit standing compared to many other emerging markets.

SPONSOR BACKING AND STRUCTURAL STRENGTHS SUPPORT ENERGY PROJECT RATINGS IN GCC
– July 31, 2023

Energy projects in the Gulf Cooperation Council that are controlled by the government or government-related entities and are deemed to be of strategic importance for the government may be rated higher than their standalone credit quality. Due to the ring-fenced nature of project financing, the rating approach is bottom-up and any rating uplift will be limited to two notches.

Fitch's special report on the topic discusses certain structural and technical strengths of GCC energy projects that may strengthen the standalone credit profile compared with international peers. Also, it is Fitch's view that the government's multiple roles in the project lead to a strong alignment of interests between the project's counterparties and may reduce project risk.

Structural and qualitative strengths are captured in Fitch rating cases to assess the safety cushion available to cover possible additional stresses and maintain debt service payments. To position the rating Fitch may apply project-specific thresholds that vary from the guidance in the relevant sector criteria to capture certain elements that may be present in projects but not fully reflected in cash flow projections.

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CONTACTS

Jay Leitner
BRM Regional - EMEA
Managing Director
+971 4 424 1222
jay.leitner@fitchratings.com

Nejoud Al Mulaik
BRM Regional - EMEA
General Manager - Saudi Arabia Office
+966 11 484 7140
nejoud.almulaik@fitchratings.com

Wael Mourad
BRM Regional - EMEA
Senior Director – Financial Institutions
+971 4 424 1204
wael.mourad@fitchratings.com

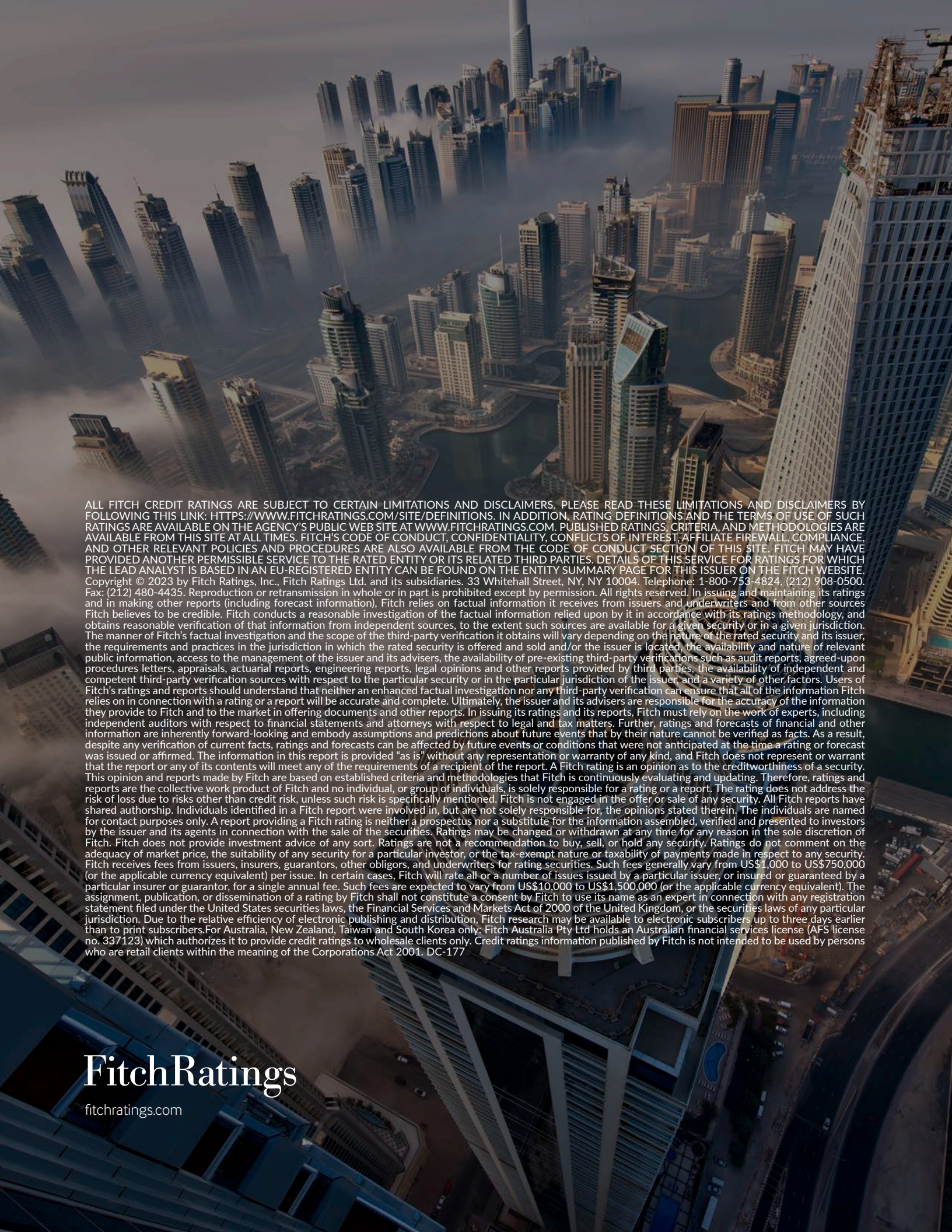
Ahmed Hassan
BRM Regional - EMEA
Senior Director – Corporates, Infrastructure & Public Finance
+971 4 424 1255
ahmed.hassan@fitchratings.com

Faisal Al-Gharabally
BRM Regional – EMEA
Senior Director – Investor Development
+971 4 424 1289
faisal.al-gharabally@fitchratings.com

Global Investor Development Team:

Aymeric Poizot
Global Head of Investor Development
+33 1 44 29 92 76
aymeric.poizot@fitchratings.com

Andrei Sandu
Head of European Investor Development
+44 20 3530 1332
andrei.sandu@fitchratings.com



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