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European Leveraged Finance 2Q’10: Sovereign Debt Crisis Overshadows All

Highlight and Market Environment

• European leveraged finance issuance, which includes leveraged loans and high yield bonds, totalled €18.6 billion in the second quarter of 2010, a decline of 40.2 percent from the revised first quarter total of €31.2 billion. As in prior quarters, issuance was primarily to refinance or restructure existing debt, either through bond-to-loan takeouts or amend-to-extend transactions.

• The steep decline in issuance was related mainly to Europe’s descent into crisis as sovereign debt concerns, particularly those eurozone countries such as Portugal, Ireland, Italy, Greece and Spain, spiralled out of control, culminating in a €750 billion rescue package to address market tensions in Europe, followed by announced austerity measures and bank stress tests.

Market and Economic Environment

• Financing conditions tightened considerably in the second quarter as Europe descended into its debt crisis, with banks reporting a net tightening of standards to both small and large borrowers. Liquidity constraints appear to have played a larger part in tightening credit standards in 2Q’10 than in prior months. Small and medium enterprises (“SME”) continue to remain more deeply impacted than large issuers on net.

• Bank balance sheets will remain constrained in the near- and medium-term. Bank stress tests, expected higher capital charges due to Basel, particularly for sub-investment grade loans and bonds, and continued hibernation of the securitisation markets will continue to keep banks in a defensive position. While the securitisation markets have eked an opening relative to 2008-2009 norms of 90+ percent retention, there are still approximately €950 billion of retained securitisations still outstanding end-June according to AFME / ESF. With ECB repo facilities set to impose higher haircuts asset-backed securities in 2011 and securitisation markets unlikely to rapidly absorb the amount of retained debt, banks are generally unable to add to their balance sheets in the near-term.

• Conversely, loan demand continued to decline in 2Q’10, albeit more slowly than in prior months. Debt restructuring remains the primary factor for loan demand, particularly as over half the leveraged deals by euro amount were for refinancing purposes, particularly to amend existing credit facilities terms, extend loan terms, or reduce the size of existing facilities. Fixed investment, mergers & acquisitions, and debt issuance remain primary contributors to decreased demand, similar to prior quarters.

Issuer: Leveraged Loans

• Leveraged loan issuance, which includes first lien, second lien, and mezzanine financing, totalled approximately €10.1 billion in 2Q’10, a decline of 50.9 percent and 28.5 percent, respectively, from 1Q’10 and 2Q’09. Mezzanine and 2nd lien financing continue to remain on the sidelines, with nearly all issuance in the second quarter comprised of first liens.

• According to Dealogic, leading sectors in 2Q’10 leveraged loan issuance in 2Q’10 were construction (€3.6 billion) and computers & electronics (€2.1 billion). HeidelbergCement AG’s €3 billion deal was the largest leveraged deal in 2Q’10, primarily to refinance their current credit facility. The second largest deal, UPC Holding BV, $(1.0 billion) was primarily an amend-to-extend transaction; more generally, approximately 16.5 percent of leveraged loan deals by euro amount contained some form of maturity extension.

• Collateralized loan obligations (CLO) issuance remains muted. According to AFME / ESF, approximately €1.8 billion of CLOs were issued in 2Q’10, €1.3 billion being SME loan deals (Valhalla II the only non-SME deal). CLO portfolios appear to be shrinking or deleveraging, with an estimated €290.2 billion of CLOs outstanding at end-June, down from an estimated peak of €310.2 billion in 2009. With bank balance sheets constrained and a shrinking investor base, the loan market continues to be weak and is subsequently reflected in the forward pipeline, which was €1.12 billion at end-June (compared to €20+ billion norms in 2007-2008), according to S&P LCD.

• While leveraged borrowers, in particular, have generally preferred to acquire financing through the loan markets rather than the bond markets due, in part, to cheaper financing relative to their credit profile and generally
smaller average issuance sizes, the absence of traditional loan investors have led to the increased reliance on the capital markets for financing. The bond market share of European issuance for leveraged debt climbed to an estimated 38.5 percent share of all issuance in the first half of 2010.

![Bond Share of European Issuance](chart.png)

- The European markets, more generally, have embraced bond issuance as an alternative funding tool, but the European bond markets remain hampered by several factor contributing to its illiquidity, according to Fitch Ratings, The contributing factors: biannual financial corporate filings versus the U.S. quarterly; limited secondary market activity, and lack of covenant transparency, among others.1

**Issuance: High Yield Bonds**

- Primary issuance in the second quarter, excluding emerging market issuance, totaled €5.9 billion on 13 deals, led by chemicals (€1.4 billion) and construction (€1.4 billion). From emerging market Europe, high yield issuance was €2.7 billion on 8 deals in 2Q’10, led by telecommunications (€707 million). Year to date, high yield issuance in 2010 is at €19.2 billion, and on track to match 2006 issuance highs.

- As in the leveraged loan sector, use of proceeds in high yield issuance were to refinance, pay down, or restructure existing debt, with 63.5 percent of all deals by euro amount used for this purpose in 2Q’10, compared to 71.1 percent and 58.3 percent, respectively, from 1Q’10 and 2Q’09.

**Returns & Credit Quality**

**Returns**

- Both European leveraged loans and high yield gave back some of their gains from the first quarter in 2Q’10; according to S&P ELLI, European leveraged loans lost 0.14 percent, while high yield, according to Bank of America-Merrill Lynch’s Euro HY index, lost 3.17 percent. Equities lost the most ground in the second quarter, while U.S. Treasuries continued to enjoy a solid 4.72 percent return due to flight to safety in the face of the European sovereign meltdown.

**Credit Quality**

- Upgrades/downgrades in Europe were predominantly from European developed market sovereigns (Greece, Portugal, the Principality of Andorra, and Spain) by dollar size, 68 actions were reported in Q2’10 by S&P, 61 of which in the European developed markets. Bank downgrades were especially heavy in 2Q, partly due to their tight coupling to their respective sovereigns’ credit as well as balance sheet exposure to stressed eurozone sovereign countries. Outside sovereigns, transportation (six downgrades), utility & telecommunications (three) were also prominent; by dollar size, integrated oil and gas dominated downgrades, stemming primarily from BP’s downgrades due to the Deepwater Horizon incident.

- Emerging market Europe, on the other hand, have enjoyed relatively stable credit profiles, with three sovereign upgrades (Georgia, Estonia, and Ukraine).

- S&P reported a decline in high yield default rates, with the high-yield trailing 12-month European default rate at 6 percent as of end-June, down from 6.59 percent end-March. Defaults continue to remain relatively muted, with only one distressed exchange reported in 2Q’10, the UK media and entertainment company, HIT Entertainment.

**Financing Needs Still Paramount**

**European Debt Issuance**

- With approximately €1.2 trillion in both bonds and loans scheduled to mature in 2010 and 2011 (not including sovereign or structured debt), of which €60.1 billion in the leveraged finance sector alone,2 refinancing concerns will continue to be elevated in the near-term, particularly as funding needs remain a concern in several European sectors.

---


According to Dealogic, European bond and loan issuance, including corporate debt issuance (both investment grade and high yield), as well as loan issuance (investment grade and leveraged), averaged €1.4 trillion annually in the 10-year period from 2000 to 2009, including the run-up period of record issuance in 2006 and 2007. While the European markets appear to be well-positioned to absorb the roll of current maturing debt at end-June, after a busy year and a half refinancing the debt wall, the situation in the near-term appears to be somewhat fragile. With €657.0 billion issued in the first half of 2010, and assuming a similar rate of debt issuance in the second half, the European capital markets appear to be capable of absorbing the estimated €506.7 billion of debt maturing through year-end. However, as S&P noted, any further deterioration in sovereign credit would have negative implications for non-sovereign European borrowers, ultimately resulting in higher borrowing costs, greater interest rate risk, and heightened competition from sovereigns for capital markets access.
1. Leveraged Finance Overview

1.1. European Leveraged Issuance, Amount

European Leveraged Issuance
2003 - 2010:Q2

1.2. European Leveraged Issuance, Percentage

European Leveraged Issuance
2003 - 2010:Q2

1.3. European Leveraged Issuance Average Deal Size

European Leveraged Issuance Average Size
2003 - 2010:Q2

1.4. European HoldCo PIK Issuance

European Holdco PIK Issuance (LTM)
2004 - 2010:Q1

1.5. Bank Credit Standards

Bank Credit Standards
Jul. 2005 - Jul. 2010

1.6. Factors Affecting Bank Credit Standards

Factors Affecting Bank Credit Standards
Jul. 2010

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1 Fitch data are as of 2010 Q1 and may be current or a quarter behind depending on publication date of this report.

2 A positive net percentage number signifies tightening bank credit; a negative net percentage number signifies easing credit.

3 A positive net percentage signifies the factor contributed to tightening credit standards; a negative net percentage signifies the factor contributed to easing credit standards.
1.7. Loan Demand

Loan Demand
Jul. 2005 - Jul. 2010

Jul-05 Jul-06 Jul-07 Jul-08 Jul-09 Jul-10

Net Percentage

-60 -50 -40 -30 -20 -10 0 10 20 30

SME Large Enterprises Overall

Source: ECB

1.8. Factors Affecting Loan Demand

Factors Affecting Loan Demand
Jul. 2010

Debt/Restructuring
Inventories, Working Capital
Internal Financing
Loans from Non-Banks
Loans from Other Banks
Equity Issuance
Debt Issuance
M&A, Restructuring
Fixed Investment

Net Percentage

Source: ECB

1.9. Global Comparison – High Yield Issuance

€ Billions

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Source: Dealogic

4 A positive net percentage signifies increased demand; a negative net percentage signifies decreased demand.

5 A positive net percentage signifies a factor that contributed to higher demand; a negative net percentage signifies a factor that contributed to lower demand.
2. Issuance – Leveraged Loans

2.1. European Leveraged Loan Issuance By Loan Type

- Leverage Loan Issuance by Loan Type 2003 - 2010:Q2

2.2. European Leveraged Loan Issuance by Industry Sector

- Leverage Loan Issuance by Industry 2010:Q2

2.3. Forward Pipeline of Leveraged Loan Market

- Forward Pipeline of Leveraged Loan Market 2008:Q1 - 2010:Q2

2.4. S&P ELLI Total Institutional Loans Outstanding

- S&P ELLI Total Institutional Loans Outstanding 2005 - 2010:Q2

2.5. S&P ELLI Ratings Diversification

- S&P ELLI Ratings Diversification 2006 - 2010:QTD

2.6. European Leveraged Loan Ratios®

- European Leveraged Loan Ratios®

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® Fitch data are as of 2010 Q1, the latest available by publication date of this report.
3. Issuance – High Yield Bonds Overview

3.1. European HY Bond Issuance, Developed and Emerging Market

3.2. European HY Bond Issuance, Sponsored vs. Corporate

3.3. European Corporate Bonds ex Banks and Financials, Outstanding

3.4. European Corporate Bonds ex Banks and Financials, Average Deal Size

3.5. European HY Use of Proceeds

3.6. European HY Issuance, Senior Secured Share
4. Issuance – European Developed Market High Yield Bonds

4.1. European Developed Market HY Bond Issuance

4.2. European Developed Market HY Issuance by Currency

4.3. European Developed Market HY Issuance by Industry

4.4. European Developed Market HY Issuance by Country of Risk

4.5. European Developed Market HY Issuance, Fixed vs. Floating

4.6. European Developed Market HY Issuance, Sponsored vs. Corporate
### 4.7. European Developed Market HY Bond Issuance Table

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Source: Bloomberg, Dealogic
5. Issuance – European Emerging Market High Yield Bonds

5.1. European Emerging Market HY Bond Issuance

5.2. European Emerging Market HY Bond Issuance by Currency

5.3. European Emerging Market HY Issuance by Industry

5.4. European Emerging Market HY Issuance by Country of Risk

5.5. European Emerging Market HY Issuance, Fixed vs. Floating

5.6. European Emerging Market HY Issuance, Sponsored vs. Corporate
## 5.7. Emerging Market HY Bond Issuance Table

<table>
<thead>
<tr>
<th>Issuer</th>
<th>Industry Group</th>
<th>Date</th>
<th>Currency</th>
<th>Amount (Millions)</th>
<th>Coupon</th>
<th>Moodys</th>
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<th>Fitch</th>
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Source: Bloomberg, Dealogic
6. Credit Quality

6.1. European HY Default Rate

6.2. European Issuer Rating Actions

6.3. European Industry Rating Actions by $ Amount

6.4. European Loan Default Rate

---

1 “European” issuer downgrades are according to S&P’s “Europe” list and may not include certain European emerging market countries. Numbers include both corporate and sovereigns.

2 Fitch data are as of 2010 Q1 and may be current or a quarter behind depending on publication date of this report.
7. Relative Value

7.1. European HY Bonds, Cash vs. Synthetic

Bonds, Cash vs. Synthetic

7.2. European Leveraged Loans, Cash vs. Synthetic

Loans, Cash vs. Synthetic

8. Total Return

8.1. European HY Bond Total Return

European High Yield Total Return
2001 - 2010:Q2

8.2. European Leveraged Loan Total Return

European Leveraged Loan Total Return
2003 - 2010:Q2

8.3. Asset Class Total Return

Asset Class Total Returns
2009:Q2 v 2010:Q2

Source: Bank of America-Merrill Lynch

Source: Thomson Reuters LPC, Markit

Source: Standard and Poor’s LCD
ELL/EUR-denominated only unavailable for 2003 and 2004.

Source: BofA-ML, Bloomberg
Summary of the Methodologies
Adopted for this Report

1. Leveraged Issuance – Overview

1.1. – 1.3. Leveraged Loans and High Yield Bonds
Leveraged loan data are sourced from Thomson Reuters LPC and Dealogic.

Leveraged loan data from Thomson Reuters LPC are defined primarily as having sub-investment grade ratings and/or a margin spread minimum of 200 basis points (spread minimums will vary from year to year to make Thomson LPC’s cutoff). Leveraged loan aggregates will include first lien, second lien, and mezzanine financing. Discrepancies in Thomson Reuters LPC data are due to rounding and/or currency rate of exchange.

Leveraged loan data from Dealogic are defined primarily as coming from a leveraged or highly leveraged European deal; loan tranches must have sub-investment grade ratings, or, if unrated, a margin spread minimum of 125 basis points over a benchmark (e.g., Euribor, LIBOR). Under these guidelines, sub-investment grade-rated loans with a margin spread of less than 125 basis points are included. Deals must be European and are inclusive of both developed and emerging market Europe as defined in high yield criteria in Section 3. Deals must also be marketed either in Europe or in the United States. Loans not EUR-denominated are converted to EUR as of credit date for purposes of aggregation. Aggregates include new money as well as non-new money deals.

Criteria for high yield bond transactions can be found in Section 3, 4, and 5.

1.4. European Holdco PIK Issuance
European LTM Holdco PIK data is sourced from Fitch Ratings. Data is displayed on a last 12 month (LTM) basis. Inclusion of certain deals in Fitch’s numbers are at the discretion and guidelines of Fitch Ratings and will not include certain hybrid and/or unusual PIK structures.

1.5. – 1.8. Bank Lending Surveys
Data for loan demand and credit standards are sourced from the ECB’s bank lending survey. Graph numbers are net percentages of reporting banks.

1.9. Global Comparison – High Yield Issuance
Data for global high yield issuance are sourced from Dealogic. Asian deals are inclusive of Japan and Australia.

2. Issuance – Leveraged Loans
2.1. – 2.2.
Leveraged loan issuance is sourced primarily from Dealogic and Thomson Reuters LPC. For more details on qualifying criteria, please refer to section 1.

2.3. Forward Pipeline of Leveraged Loan Market
Forward leveraged loan pipeline data are sourced from S&P LCD.

2.4. S&P ELLI Total Institutional Loans Outstanding
Total institutional loan outstanding data are sourced from S&P LCD and are outstanding loans in the S&P ELLI index.

2.5. S&P ELLI Ratings Diversification
S&P ELLI ratings diversification are the percentages of currently outstanding loans in S&P’s ELLI index that are rated accordingly. Data are provided by S&P LCD.

2.6. European Leveraged Loan Ratios
European leveraged loan ratios are sourced from Fitch Ratings and are a debt/EBITDA ratio across Fitch’s shadow rated universe. Transactions included in the ratio include new as well as existing transactions and ratings may be assigned at various points in time throughout the year.

2.7. – 2.8. Loan Spreads
Loan spread data are sourced from Dealogic under our criteria for leveraged loans (see Section 1). For purposes of loan spread calculations, deals marketed in the US are excluded. Spreads are a weighted average of spread margin on new leveraged issuance on a rolling twelve months basis, and are typically benchmarked to LIBOR or EURIBOR. Institutional loan spread data is inclusive of 2nd lien; pro rata spreads include all revolvers and term loan A (Tla).

3. Issuance – High Yield Bonds Overview
High yield bond transactions are sourced primarily from Dealogic, with supplemental information sourced from Bloomberg. High yield transactions are defined as transactions with a Dealogic “effective” rating of equal or less than BB+, and may include unrated transactions based on issuer and desk notes. Split-junk rated transactions are generally excluded.

European issuance, inclusive of both emerging market Europe and developed market Europe, is defined as an issue having a Dealogic “deal nationality” as well as “nationality of risk” within Europe issued in the euro, foreign, and global markets; deals marketed locally are excluded. Sovereign, sub-sovereign, and supranational parent issuers are excluded from issuance, as well as ABS/MBS issuers.

Emerging market Europe and developed market European issuance are defined by nationality of risk, rather than nationality of deal, and although primarily sourced from Dealogic, is ultimately subject to EHYA’s discretion. Emerging and developed market issuance are mutually exclusive and will contain no overlap unless otherwise mentioned.

European emerging market bonds are further defined with having a minimum deal size of €75.0 million; deals on the same day from the same issuer are aggregated for the purpose of meeting this minimum. Russian ruble (RUB)-denominated issuance are excluded due to differences in terms and documentation.
3.2. European HY Issuance by Sponsor
Data for high yield issuance by sponsor are sourced from Dealogic. LBO deals are defined as all high yield transactions whose issuer parent is a public or private finance entity (i.e., a financial sponsor), regardless of use of proceeds.

3.3. – 3.4. European Corporate Bonds Outstanding
Data for European corporate outstanding are sourced from Bloomberg and AFME/SIFMA estimates. Criteria for European corporate bonds are: bonds must be placed in the euro, foreign, and global markets (domestically placed issues are excluded) with a nationality of issue and risk from a European developed or emerging market country as defined by AFME / EHYA. Corporate bonds exclude all issuance from banks and financials, and additionally excludes all covered bonds, warrants, deposit notes, receipts, and certificates of deposit. No currencies are excluded in this analysis and all non-EUR currencies are converted to EUR at end-quarter exchange rates.

To qualify as an investment grade corporate bond, a security must have a minimum of one investment grade rating from Moody’s, Standard and Poor’s, or Fitch Ratings. Split-rated securities are also included in investment-grade numbers. To qualify as a high yield corporate bond, a security must have a minimum of one sub-investment-grade rating from Moody’s, Standard and Poor’s, or Fitch Ratings; withdrawn ratings are not counted for purposes of determining high yield. Unless otherwise specified, high yield outstanding totals in discussion commentary will include non-rated securities, regardless of the credit quality of the debt or issuer.

Corporate bonds outstanding include certain securities that may be considered corporate securitisations or structured finance securities; while all effort is made to exclude the latter, the former will be counted toward the corporate bonds outstanding total, and will subsequently overlap to some extent to AFME / ESF structured finance outstanding numbers.

3.5. European HY Issuance By Use of Proceeds
Data for HY issuance by use of proceeds are sourced from Dealogic and aggregated for the purposes of this calculation. Please refer to Section 3 for criteria on high yield issue inclusion.

3.6. European HY Issuance, Senior Secured Share
Data for HY issuance by seniority are sourced from Dealogic and Bloomberg. “Senior Unsecured” totals include all bonds that are senior but not senior secured.

4. Issuance – European Developed Market High Yield Bonds
4.1. – 4.7.
High yield bond issuance data are sourced from Dealogic. For further criteria on how high yield issuance are defined, please refer to section 3.

Developed European issuance are deals predominantly from western Europe and includes deals from Andorra, Austria, Belgium, Bulgaria, Cyprus, Switzerland, Germany, Denmark, Spain, Estonia, Finland, France, Faroe Islands, United Kingdom, Guernsey, Gibraltar, Greenland, Greece, Isle of Man, Ireland, Iceland, Italy, Jersey, Liechtenstein, Luxembourg, Monaco, Malta, Montenegro, Netherlands, Norway, Portugal, San Marino, and Sweden.

5. Issuance – European Emerging Market High Yield Bonds
5.1. – 5.7.
High yield bond issuance data are sourced from Dealogic. Criteria for all high yield issuance are found in section 3.

Emerging market European issuance deals are predominantly from eastern Europe but will also additionally include Turkey, the Russian Federation, Kazakhstan, Turkmenistan, Uzbekistan, Tajikistan, Azerbaijan, and Kyrgyzstan. Certain sub-investment grade countries are not included in the emerging market total, including, among others, Iceland and Greece.

6. Credit Quality
6.1. European HY Default Rate
European HY bond default rates are sourced from S&P and are on a trailing 12 month basis.

“Europe” for the S&P default rate is defined to include Austria, Belgium, Bulgaria, Channel Islands, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland and the United Kingdom. Countries are subject to revision.

6.2. European Issuer Rating Actions
European issuer upgrades and downgrades are sourced from S&P. The list of countries included under S&P Europe’s upgrade and downgrade numbers are listed in section 6.1. Multiple downgrades of a single issuer are counted separately. Rating actions are inclusive of both corporate as well as sovereign downgrades.

6.3. European Issuer Rating Actions by $ Amount
Rating actions by US dollar amount, industry, and country are sourced from S&P. Breakdown by emerging market and developed Europe are from AFME / EHYA’s definition of developed and emerging markets and would be, under S&P’s guidelines, a combination of both European and EMEA rating actions.

6.4. European Loan Default Rate
European loan default rates, both mezzanine and senior leveraged loans, are sourced from Fitch Ratings and are on a LTM basis.

Adjusted rates for both mezzanine and senior loans are inclusive of Fitch’s CC*/C* shadow-rated leveraged credits, whereas un-adjusted rates are exclusive of these rated credits. Senior leveraged loan data is available only for 2009.
7. Cash and Synthetic
7.1. – 7.2. Loans and Bonds, Cash and Synthetic
Data are sourced from Markit and Thomson Reuters LPC. High yield bond cash and synthetic spreads from Markit; European leveraged loan cash bid prices from Thomson Reuters LPC, and European leveraged loans synthetic prices from Markit.

8. Total Return
8.1. European HY Bond Total Return
European HY bond total return data are sourced from the Bank of America-Merrill Lynch’s Euro High Yield Index (HE00). The index tracks the performance of EUR-denominated below-investment-grade corporate debt publicly issued in the euro domestic or Eurobond markets. Qualifying securities must have a below-investment-grade rating and an investment-grade rated country of risk. Qualifying securities must have at least one year remaining term to maturity, fixed coupon schedule and minimum amount outstanding of €100 million. Original issue zero coupon bonds, “global securities” (debt issued simultaneously in the Eurobond and euro domestic markets), 144a securities and pay-in-kind securities, including toggle notes, qualify for inclusion in the index. Callable perpetual securities qualify provided they are at least one year from the first call date. Fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. Defaulted, warrant-bearing and euro legacy currency securities are excluded from the index.

8.2. European Leveraged Loan Total Return
Total return data are provided by S&P LCD and are total returns from S&P’s ELLI index, both ELLI and EUR-denominated ELLI. Total returns for ELLI EUR-denominated data are unavailable for 2003 and 2004.

8.3. Asset Class Total Return (Cash Basis)
Total returns are sourced from respective index owners and Bank of America-Merrill Lynch’s indices.

Disclaimer
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