

Infosys Technologies

STOCK INFO.	BLOOMBERG
BSE SENSEX: 10,930	INFO IN
	REUTERS CODE
S&P CNX: 3,196	INFY.BO

12 July 2006

Buy

Previous Recommendation: Buy

Rs3,386

		YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
		END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
Equity Shares (m)	276.8	3/06A	95,216	24,583	89.3	29.4	37.9	13.4	40.3	45.2	9.2	28.4
52-Week Range	3,400/2,122	3/07E	135,410	36,027	130.1	45.8	26.0	9.6	43.1	48.6	6.5	20.2
1,6,12 Rel. Perf. (%)	7/3/3	3/08E	172,264	43,312	156.4	20.2	21.6	7.1	37.7	42.8	5.0	15.9
M.Cap. (Rs b)	937.5											
M.Cap. (US\$ b)	20.3											

- Infosys reported revenues of Rs30.2b for 1QFY07, up 14.9% QoQ, beating our estimate of Rs29b. This was primarily due to rupee depreciation and strong volume growth. Gross margins declined 110bp QoQ, primarily due to salary hikes offered to employees during the quarter. EBITDA margins were down 230bp QoQ to 29.5%.
- Translation gains of Rs800m and hedging loss of around Rs280m resulted in a forex gain of Rs520m. Therefore, other income was higher at Rs1,250m. Depreciation as a percentage of sales was lower due to the absence of accelerated amortization expenses incurred in 4QFY06. Net profit increased by 18.9% QoQ to Rs8b.
- Infosys has revised its revenue guidance for FY07 up to Rs133.5-134b, implying growth of 40.2-40.7% (earlier growth guidance was 28.7-30.7%). The management expects EPS for the year at Rs124.51-Rs125.74, implying growth of 38.3-39.6% (earlier growth guidance was 26.4-28.4%). The revision in revenue guidance is on the back of an estimated 34% volume growth.
- To factor in the company's better than expected performance, we have revised our estimates for FY07 and FY08. We now expect sales growth of 42.2% in FY07 and 27.2% in FY08. We have revised our EPS estimate up by 8.3% for FY07 to Rs130.1 (earlier estimate of Rs120.9) and by 5.6% for FY08 to Rs156.4 (earlier estimate of Rs148.1). Infosys trades at 26x FY07E and 21.6x FY08E EPS. Despite the sharp run up in price, we reiterate Infosys as our top pick in the IT sector, with a price target of Rs3,910 (earlier price target Rs3,730) – an upside of 15.5%.

QUARTERLY PERFORMANCE

(Rs Million)

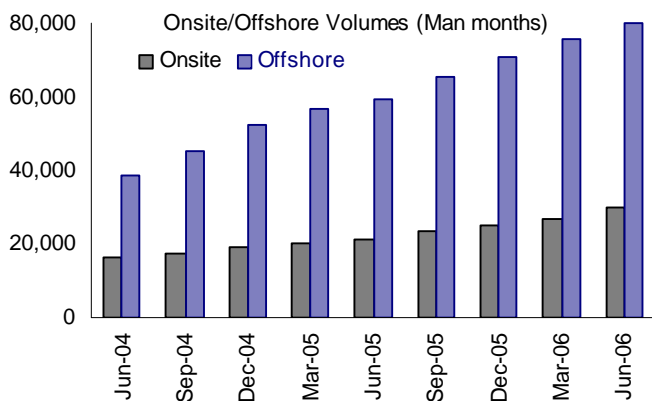
Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Revenues	20,716	22,940	25,320	26,240	30,150	32,925	35,125	37,210	95,216	135,410
Q-o-Q Change (%)	4.2	10.7	10.4	3.6	14.9	9.2	6.7	5.9	33.5	42.2
Direct Expenses	11,044	12,120	13,270	14,220	16,660	17,893	18,460	19,607	50,654	72,620
Sales, General & Admin. Expenses	3,033	3,480	3,440	3,690	4,600	4,708	4,759	5,042	13,643	19,110
Operating Profit	6,638	7,340	8,610	8,330	8,890	10,323	11,905	12,562	30,918	43,680
Margins (%)	32.0	32.0	34.0	31.7	29.5	31.4	33.9	33.8	32.5	32.3
Other Income	286	440	-50	720	1,250	588	667	697	1,396	3,202
Depreciation	801	960	1,170	1,440	1,060	1,482	1,668	1,767	4,371	5,978
PBT bef. Extra-ordinary	6,123	6,820	7,390	7,610	9,080	9,430	10,904	11,491	27,943	40,905
Provision for Tax	802	690	830	810	1,060	1,084	1,281	1,333	3,132	4,759
Rate (%)	13.1	10.1	11.2	10.6	11.7	11.5	11.8	11.6	11.2	11.6
PAT bef. Minority	5,331	6,130	6,560	6,800	8,020	8,345	9,623	10,158	24,793	36,146
Minority Interest	-2	-60	-70	-70	-80	-11	-13	-15	-210	-119
Extra-ordinary items	0	-10	0	0	60					60
PAT aft. Minority and ext-ord	5,330	6,060	6,490	6,730	8,000	8,335	9,609	10,144	24,583	36,087
Q-o-Q Change (%)	3.8	13.7	7.1	3.7	18.9	4.2	15.3	5.6	33.1	46.8

E: M0St Estimates

Near 15% QoQ revenue growth, a positive surprise

Infosys reported revenues of Rs30.2b for 1QFY07, up 14.9% QoQ, beating our estimate of Rs29b. This was primarily due to rupee depreciation of 3.3% in realized rate for Infosys besides strong volume growth of 7.5% QoQ. Onsite billing rates increased by 1.2%, while offshore billing rates increased by 2.8% QoQ. Average consolidated billing rates increased 3.5% during the quarter. Increase in blended rate is also on account of increase in onsite composition. The management has indicated that new deals are signed at 3-4% higher rates. MSA renegotiations with existing clients have resulted in 2-3% increase in rates. However, the volume discount to large clients, especially those over US\$100m, is likely to nullify the hike in billing rates.

CONSISTENT INCREASE IN VOLUME GROWTH DESPITE HIGHER BASE



Source: Company/ Motilal Oswal Securities

Higher revenue growth was also due to increase in onsite composition, which increased to 50.5% from 49.3% in 4QFY06. Higher onsite growth is usually an indication of the startup of projects, which is likely to translate into higher offshore work in the coming quarters. This is due to the high onsite composition during the knowledge phase and the subsequent transition of work offshore. This also indicates higher discretionary spending, which management expects to continue in the coming quarter.

REVENUE MIX (%)

	JUN-05	SEP-05	DEC-05	MAR-06	JUN-06
Onsite	47.90	48.80	48.60	49.30	50.5
Offshore	52.1	51.2	51.4	50.7	49.5

Source: Company/ Motilal Oswal Securities

BFSI, Manufacturing, Telecom power growth

Among the various verticals, Telecom grew strongest at 24.8% QoQ. BFSI also registered robust growth, with BFS growing 15.7% QoQ and Insurance growing 18.3% QoQ. Utilities also grew at a robust 17.1% QoQ. Manufacturing grew in line with the company average at 14.9%. The strong growth in these sectors is expected to continue through the rest of FY07 due to increasing IT spends in these sectors as well as increased offshoring.

REVENUE BY VERTICAL (% QOQ GROWTH)

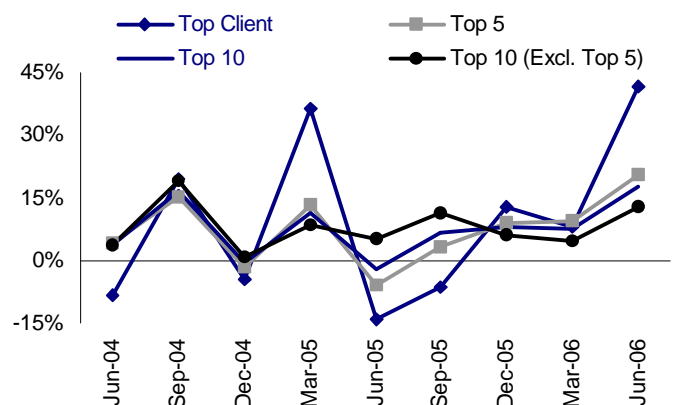
	JUN-05	SEP-05	DEC-05	MAR-06	JUN-06
BFS	16.3	10.3	15.1	4.3	15.7
Insurance	-0.5	4.1	-2.2	0.7	18.3
Manufacturing	-1.0	12.4	15.3	6.6	14.9
Telecom	-7.6	7.5	4.4	6.9	24.8
Retail	10.0	21.1	8.3	2.6	9.3
Utilities	20.5	28.7	36.0	3.6	17.1
Transport. & Logistics	-9.9	-11.4	-11.3	-17.1	5.3
Others	-70.6	20.2	22.0	11.0	9.8

Source: Company/ Motilal Oswal Securities

Client mining continues at a brisk pace – two US\$100m clients

The company's top client grew by a whopping 41.8% QoQ, with the top client's revenue contribution increasing to 5.8% from 4.7% in FY06. Other top clients also grew robustly during the quarter – the top 2-5 clients grew 13.2% QoQ and top 6-10 clients grew 13% QoQ. Non-top clients grew 13.7% QoQ.

TOP CLIENTS BOOST REVENUE GROWTH DURING THE QUARTER



Source: Company/ Motilal Oswal Securities

Infosys continues to effectively mine existing client accounts as is evident from the continued transition of a greater number of clients to higher revenue brackets. The company has effectively transitioned two accounts to the over US\$100m bracket. The number of >US\$90m clients has increased to two, while the number of clients >50m has increased to 11.

CLIENT PROFILE (NOS)

	JUN-05	SEP-05	DEC-05	MAR-06	JUN-06
Clients> US\$1m	172	191	206	221	221
Clients> US\$5m	73	76	78	81	94
Clients> US\$10m	43	48	51	54	56
Clients> US\$50m	5	6	7	9	11
Clients> US\$60m	4	4	5	0	0
Clients> US\$70m	3	2	2	4	3
Clients> US\$80m	1	1	2	0	0
Clients> US\$90m	1	1	1	1	2
Clients> US\$100m	0	0	0	0	2

Source: Company/ Motilal Oswal Securities

Last quarter, we had mentioned that company had ramped-up its sales team and is re-training its sales force to effectively cross-sell its new service lines to existing top clients. Consequently, transition to higher brackets has improved. Client addition has been robust, with the company adding 38 clients in 1QFY07. 50 new sales personnel were added during the quarter, which is likely to add to the current pace of client mining and growth.

NET CLIENT ADDITION CONTINUES TO IMPROVE

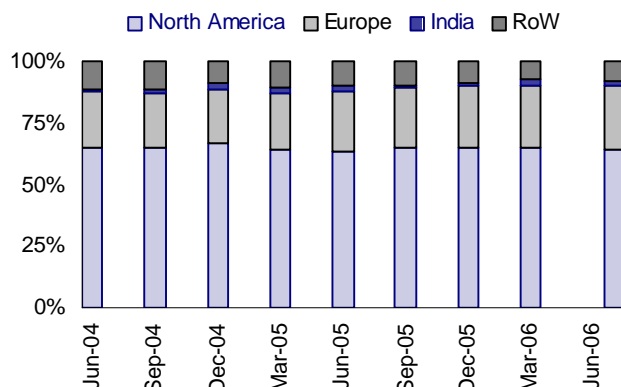


Source: Company/ Motilal Oswal Securities

Higher contribution from Europe

Europe continued to gain traction, growing at 18.1% QoQ; North America grew 13.1% QoQ; while RoW grew 25.3% QoQ. India declined by 10.6% QoQ during the quarter. Revenue contribution from Europe increased to 26.2% from an average of 24.5% in FY06. Our interaction with the management suggests that Europe would be the powerhouse for growth in the coming quarters due to opening up of offshoring opportunities. Europe has higher than company average margins (around +100-200bp) due to the relative immaturity of the market. Higher revenue contribution from Europe is, therefore, likely to be beneficial to margins.

REVENUE CONTRIBUTION FROM EUROPE IS ON THE RISE



Source: Company/ Motilal Oswal Securities

New services growth continues to outpace core IT services

New service lines, which include package implementation, consulting, testing and BPO, grew 14.9% QoQ, outpacing traditional ADM services. Core IT services also grew at a healthy 11.9% QoQ on the back of 21.8% QoQ growth in development services. This is due to the higher amount of discretionary spending among clients, who are currently investing in new IT systems and re-haul of existing systems. Infosys expects that the increase in discretionary expenses would continue over the next 2-3 quarters as well. This would bode well for all IT players that are likely to see strong growth in higher-margin development services.

REVENUE MIX (RS M)

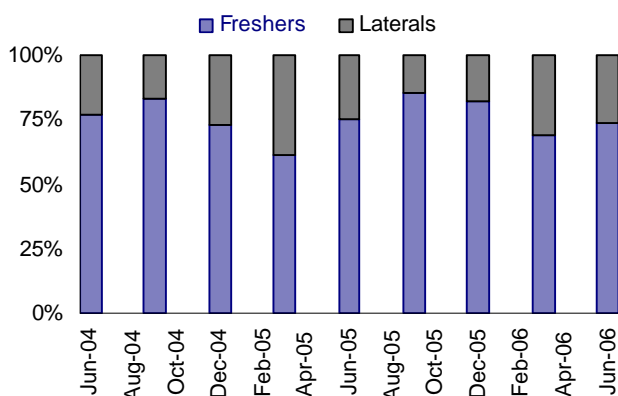
	DEC-04	MAR-05	JUN-05	SEP-05	DEC-05	MAR-06	JUN-06
Core IT	11,347	11,904	11,746	12,984	14,559	14,983	16,763
Change (%)	3.3	4.9	-1.3	10.5	12.1	2.9	11.9
New service lines	5,270	5,704	6,153	6,813	7,317	7,846	9,015
Change (%)	15.0	8.2	7.9	10.7	7.4	7.2	14.9

Source: Company/ Motilal Oswal Securities

Front-ended employee addition policy results in gross addition of 8,097

The company added 8,097 employees (net 5,957), of which lateral addition was 2,140. The lateral addition amounts to 26.4% of gross recruitment (37.6% of net addition), indicating strong volume growth in 2QFY07. This would ensure a healthy mix of freshers and laterals, in addition to boosting utilization levels for the company. Employee addition would be front-ended in FY07, with a gross addition of 7,000 employees expected in 2QFY07 and 10,000 in 2HFY07. This would enable the company to respond to client requirements and ramp up faster.

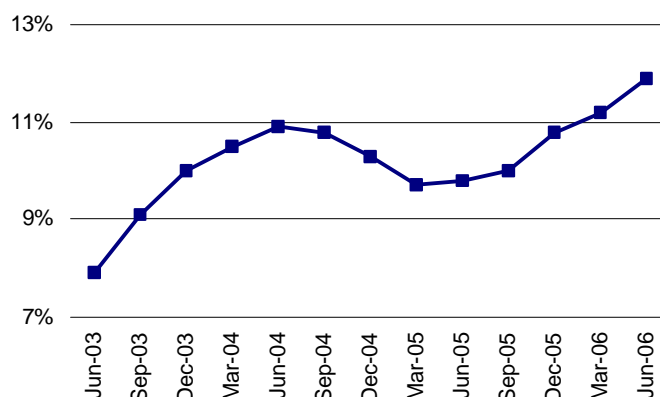
LATERAL AS A PROPORTION OF TOTAL RECRUITS REMAIN HEALTHY



Source: Company/ Motilal Oswal Securities

Employee attrition continued to increase during the quarter, rising to 11.9% from 11.2% in 4QFY07. The increasing trend in attrition rates is indicative of the tight supply scenario and could result in continuing cost pressures due to wage inflation and higher recruitment costs.

RISING ATTRITION RATES, A CAUSE FOR CONCERN



Source: Company/ Motilal Oswal Securities

Wage hikes, visa costs, SG&A pull margins down by 230bp

Infosys offered salary hikes of 3% onsite and 14-15% offshore, which depressed operating margins by 3.3%. Visa costs of US\$11m also impacted margins 1.3% during the quarter (US\$3m in 4QFY06). S&M expenses were up by 100bp due to addition of 50 sales personnel during the quarter. G&A also increased by 20bp during the quarter.

Rupee depreciation during the quarter (3.3% against the USD and 9.3% against the Euro and the Pound) prevented a steep fall in margins during the quarter. Rupee depreciation had a positive impact to the extent of 2.2% on operating margins during the quarter. Consequently, the fall in margins was arrested at 230bp to 29.5%.

WHAT IMPACTED MARGINS (BP)

COST	IMPACT ON MARGIN
Direct Costs	-110
S&M Expenses	-100
G&A Expenses	-20
Total	-230

Source: Company/ Motilal Oswal Securities

Going forward, we expect margins to recover due to improved utilization rates, absence of high visa costs, and higher return on S&M expenses. We expect margins to strengthen over 2HFY07.

Forex gains push up net profit by 18.9%

Infosys had translation gains of Rs800m during the quarter as against a hedging loss of Rs280m. This resulted in forex gain of Rs520m (Rs1.9/share) as against expectations of forex loss during the quarter. Other income was, therefore, higher at Rs1,250m. Depreciation as a percentage to sales was lower due to the absence of accelerated amortization expenses incurred in 4QFY06 for some leased assets in subsidiaries. Consequently, net profit increased by 18.9% QoQ to Rs8b.

Significant revision in dollar revenue guidance indicates strong volume growth

Infosys has revised the revenue guidance (Indian GAAP Consolidated) for FY07 upwards to Rs133.5-134b, implying YoY growth of 40.2-40.7% (earlier growth guidance was 28.7-30.7%). The management expects EPS for the year at Rs124.51-Rs125.74, implying growth of 38.3-39.6% (earlier growth guidance was 26.4-28.4%). The revision in dollar guidance for revenue growth (US GAAP Consolidated) in FY07 from 28-30% to 35.4-35.9% is indicative of the robust demand scenario and business

pipeline for the company. The management has guided for 34% YoY growth in volumes in FY07, which is also very robust.

2QFY07 profit guidance muted due to expectations of lower other income

Infosys has guided for revenue of Rs32.57-Rs32.8b for 2QFY07, a QoQ growth of 8-8.8%. The guidance for EPS growth is muted at Rs29.47-29.78, an implied growth of 2.8-3.8%. Margins are expected to expand due to lower visa costs and better utilization rates. Therefore, the low profit guidance is on account of expectations of lower other income during the quarter.

We reiterate Infosys as our top pick

We have revised our estimates for FY07 and FY08. We now expect sales growth of 42.2% in FY07 and 27.2% in FY08. We have revised our EPS estimates upward by 8.3% for FY07 to Rs130.1 (earlier estimate of Rs120.9) and by 5.6% for FY08 to Rs156.4 (earlier estimate of Rs148.1).

Infosys trades at 26x FY07E and 21.6x FY08E EPS. Despite the sharp-run up in stock price, we reiterate Infosys as our top pick in the IT sector considering its strong earnings visibility. We maintain our **Buy** recommendation with a price target of Rs3,910 (earlier price target Rs3,730) – an upside of 15.5%.

Infosys Technologies: an investment profile

Company description

Infosys is the second largest IT company in India with revenues of more than US\$2b and employing over 55,000 people. It provides IT as well as BPO services to more than 450 clients. It is the preferred vendor for a majority of the Fortune 500/Global 1,000 companies. Its top clients include DHL, Telstra, American Express, Goldman Sachs, Cisco, Fidelity and Bank of America.

Key investment arguments

- ✎ Excellent project execution skills make it the preferred vendor for most clients
- ✎ Differentiates itself by innovating offshore delivery of services in various forms
- ✎ Sustained competitive advantage to enable it to maintain its leadership position

Key investment risks

- ✎ Rapid hiring could hurt margins if demand declines
- ✎ Weak R&D services and infrastructure management services practice could result in it losing out on large outsourcing deals
- ✎ Higher mix of freshers in overall employee base could impact quality of services

Recent developments

- ✎ Mr. Narayan Murthy steps down from executive Chairman effective 20 August 2006. He will continue to serve as non-executive Chairman and Chief Mentor.
- ✎ Mr. Nandan Nilekani would take over as CEO and MD, effective 20 August 2006.

Valuation and view

- ✎ CAGR of 34.5% and 32.7% in revenues and profit respectively over FY06-FY08E.
- ✎ Valuations at of 21.6x FY08E look very attractive.
- ✎ We maintain Buy for a price target of Rs3,910, upside of 15.5%.

Sector view

- ✎ Various CIO surveys indicate increasing share of offshore spending in IT budgets
- ✎ Indian offshore vendors gaining market share in competition with MNCs
- ✎ We prefer large companies, as bulk of volumes are going to them; niche players are benefiting due to lack of offshore competition

COMPARATIVE VALUATIONS

		INFOSYS	TCS	WIPRO
P/E (x)	FY07E	26.0	25.0	26.6
	FY08E	21.6	20.3	22.0
P/BV (x)	FY07E	9.6	11.3	7.4
	FY08E	7.1	7.9	6.0
EV/Sales (x)	FY07E	6.5	5.1	4.8
	FY08E	5.0	4.0	3.7
EV/EBITDA (x)	FY07E	20.2	19.0	19.5
	FY08E	15.9	15.0	15.5

EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	130.1	119.1	9.2
FY08	156.4	148.4	5.4

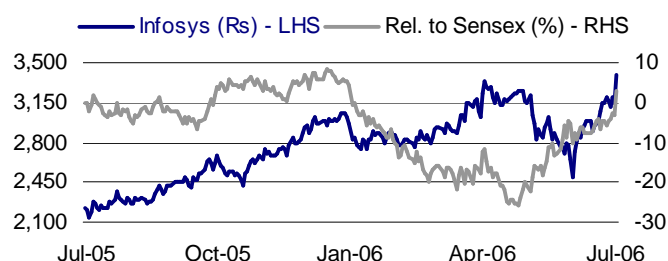
TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
3,386	3,910	15.5	Buy

SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	19.5	19.6	21.8
Domestic Institutions	6.5	5.4	4.8
FII's/FDIs	56.4	57.8	52.5
Others	17.6	17.2	20.9

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
Sales	47,609	71,296	95,216	135,410	172,264
Change (%)	31.4	49.8	33.5	42.2	27.2
Software Develop. Exp.	24,953	37,647	50,654	72,620	94,901
Selling and Mktg. Exp.	3,351	4,610	6,005	8,593	10,680
Administration Exp.	3,469	5,690	7,639	10,517	12,953
EBITDA	15,837	23,350	30,918	43,680	53,731
% of Net Sales	33.3	32.8	32.5	32.3	31.2
Depreciation	2,309	2,869	4,371	5,978	7,752
Other Income	1,274	1,239	1,396	3,202	3,313
PBT	14,801	21,720	27,943	40,905	49,292
Tax	2,270	3,256	3,132	4,759	5,915
Rate (%)	15.3	15.0	11.2	11.6	12.0
Extraordinary		452	-18	60	0
PAT	12,531	18,916	24,793	36,206	43,377
Minority Interest			210	119	65
Net Income	12,531	18,916	24,583	36,087	43,312
Change (%)	30.8	51.0	30.0	46.8	20.0

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
Share Capital	333	1,353	1,380	1,384	1,384
Share Premium	4,609	8,999	15,430	15,430	15,430
Reserves	27,554	41,900	52,850	81,130	115,061
Net Worth	32,496	52,251	69,660	97,944	131,875
Preference Capital	936	935	0	0	0
Minority Interest	0	0	680	119	184
Loans	0	0	0	0	0
Capital Employed	33,431	53,188	70,340	98,063	132,059
Gross Block	16,337	22,873	29,830	51,940	71,940
Less : Depreciation	8,098	10,308	13,280	19,258	27,009
Net Block	8,238	12,565	16,550	32,682	44,931
CWIP	2,081	3,177	5,710	5,000	3,000
Investments	9,455	12,108	7,550	17,500	20,000
Curr. Assets	31,340	39,664	63,990	67,431	98,165
Debtors	6,515	13,220	16,080	24,729	27,187
Cash & Bank Balance	17,215	15,756	34,290	21,832	48,093
Loans & Advances	7,211	10,244	12,970	20,070	21,962
Other Current Assets	400	444	650	800	923
Current Liab. & Prov	17,682	14,326	23,460	24,550	34,036
Creditors	4,499	5,354	7,320	10,487	12,167
Other liabilities	1,310	1,207	2,020	2,142	3,126
Provisions	11,872	7,766	14,120	11,920	18,743
Net Current Assets	13,658	25,338	40,530	42,881	64,130
Application of Funds	33,431	53,187	70,340	98,063	132,060

E: M0St Estimates

RATIOS					
Y/E MARCH	2004	2005	2006	2007E	2008E
Basic (Rs)					
EPS*	47.0	69.0	89.3	130.1	156.4
Cash EPS*	55.9	81.4	105.1	151.9	184.5
Book Value	121.9	195.2	252.8	353.8	476.4
DPS	32.4	12.9	44.9	24.8	29.7
Payout %(Incl.Div.Taxes)	77.3	20.6	57.4	21.7	21.7
Valuation (x)					
P/E		49.1	37.9	26.0	21.6
Cash P/E		41.6	32.2	22.3	18.4
EV/EBITDA		38.3	28.4	20.2	15.9
EV/Sales		12.5	9.2	6.5	5.0
Price/Book Value		17.3	13.4	9.6	7.1
Dividend Yield (%)		0.4	1.3	0.7	0.9
Profitability Ratios (%)					
RoE	41.0	44.6	40.3	43.1	37.7
RoCE	47.7	50.2	45.2	48.6	42.8
Turnover Ratios					
Debtors (Days)	50	68	62	67	58
Fixed Asset Turnover (x)	2.9	3.1	3.2	2.6	2.4
Leverage Ratio (x)					
Debt/Equity Ratio(x)	0.0	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
CF from Operations	14,840	21,333	29,182	42,124	51,129
Cash for Working Capital	-10,773	13,095	-3,549	14,659	-5,135
Net Operating CF	25614	8238	32731	27465	56264
Net Purchase of FA	-4,918	-7,633	-9,490	-21,400	-18,000
Net Purchase of Invest.	-7,113	-3,574	4,558	-9,950	-2,500
Net Cash from Invest.	-12031	-11207	-4932	-31350	-20500
Proceeds from Pvt. Place.	0	5,409	6,458	4	0
Proceeds from LTB/STB	0	0	0	0	0
Dividend Payments	-9,730	-3,900	-15,723	-8,577	-9,504
Cash Flow from Fin.	-9730	1509	-9265	-8572	-9504
Free Cash Flow	7,478	20,695	605	23,241	6,065
Net Cash Flow	3853	-1459	18534	-12457	26260
Opening Cash Balance	13,362	17,215	15,756	34,290	21,833
Add: Net Cash	3,853	-1,459	18,534	-12,457	26,260
Closing Cash Balance	17,215	15,756	34,290	21,833	48,092



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Disclosure of Interest Statement

Infosys Technologies

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|---|----|
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