

Blue Star

| | |
|--------------------|--------------|
| STOCK INFO. | BLOOMBERG |
| BSE SENSEX: 15,235 | BLSTR IN |
| | REUTERS CODE |
| S&P CNX: 4,445 | BLUS.BO |

27 July 2007

Buy

Previous Recommendation: Buy

Rs275

| | | YEAR | NET SALES | PAT | EPS | EPS | P/E | P/BV | ROE | ROCE | EV/ | EV/ |
|-------------------------|----------|--------|-----------|--------|------|---------|------|------|------|------|-------|--------|
| | | END | (RS M) | (RS M) | (RS) | YoY (%) | (X) | (X) | (%) | (%) | SALES | EBITDA |
| Equity Shares (m) | 89.9 | 03/07A | 16,013 | 712 | 7.9 | 45.6 | 34.7 | 11.6 | 36.9 | 36.1 | 1.6 | 21.9 |
| 52-Week Range | 293/118 | 03/08E | 22,418 | 1,142 | 12.7 | 60.5 | 21.7 | 8.7 | 46.1 | 47.9 | 1.2 | 13.7 |
| 1, 6, 12 Rel. Perf. (%) | 12/18/85 | 03/09E | 29,143 | 1,572 | 17.5 | 37.6 | 15.7 | 6.6 | 47.6 | 55.5 | 0.9 | 9.8 |
| M. Cap. (Rs b) | 24.7 | | | | | | | | | | | |
| M. Cap. (US\$ b) | 0.6 | | | | | | | | | | | |

- 1QFY08 PAT up 206% YoY:** Blue Star's 1QFY08 results are significantly above expectation. Revenue is up 48% YoY (expected 30%), EBITDA up 139% YoY and PAT up 206% YoY at Rs223m (expected Rs99m, up 35% YoY). EBITDA margin has expanded 300bp to 8.2%, led by (1) economies of scale and (2) full benefit of excise-free room AC plant at Himachal Pradesh.
- IT and retail/entertainment sectors driving demand:** Major orders booked during 1QFY08 confirm that Blue Star continues to benefit from at least two of our identified mega trends, IT/ITeS and Retail/Entertainment. It bagged several multiple location orders during the quarter including from Infosys, Reliance Communications, Vishal Retail and Aditya Birla Retail. Benefits of other two mega-trends – SEZs and cold chain – should accrue in years to come.
- 20% upgrade in FY08 and FY09 EPS estimates:** Even after a strong 48% income growth in 1QFY08, Blue Star's order book is up 43% YoY at Rs9.8b. The company also plans to increase its business opportunity by building competencies to take up complete electro-mechanical projects. Considering all this, we have revised our FY08 income growth rate from 30% to 40%. This leads to 60bp higher margin over our earlier estimates, and a 20% upgrade in our EPS estimate to Rs12.7 for FY08 and Rs17.5 for FY09. FY07-09 EPS CAGR is a robust 49%.
- Valuation to remain rich; 27% upside; Buy:** The stock trades at 21.7x FY08E and 15.7x FY09E EPS. We believe Blue Star will continue to enjoy rich valuation given high earnings growth, RoE of over 45%, and dividend payout of 40%. We have valued Blue Star at 20x FY09E EPS to arrive at a target price of Rs350, a 27% upside from current levels. Maintain **Buy**.

| QUARTERLY PERFORMANCE | | | | | | | | | | (RS MILLION) | |
|-------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|---------------|---------------|--|
| Y/E MARCH | FY07 | | | | FY08 | | | | FY07 | FY08E | |
| | 1Q | 2Q | 3Q | 4Q | 1Q | 2QE | 3QE | 4QE | | | |
| Operating Income | 3,123 | 3,759 | 3,701 | 5,429 | 4,623 | 5,263 | 5,182 | 7,351 | 16,013 | 22,418 | |
| Change (%) | 35.8 | 33.0 | 40.4 | 36.4 | 48.0 | 40.0 | 40.0 | 35.4 | 36.3 | 40.0 | |
| Total Expenses | 2,965 | 3,431 | 3,463 | 4,985 | 4,243 | 4,781 | 4,819 | 6,695 | 14,844 | 20,538 | |
| EBITDA | 158 | 328 | 238 | 445 | 379 | 482 | 363 | 656 | 1,169 | 1,880 | |
| Change (%) | 36.1 | 67.5 | 52.2 | 11.7 | 139.4 | 46.9 | 52.5 | 47.4 | 34.9 | 60.8 | |
| EBITDA Margin (%) | 5.1 | 8.7 | 6.4 | 8.2 | 8.2 | 9.2 | 7.0 | 8.9 | 7.3 | 8.4 | |
| Depreciation | 43 | 46 | 58 | 62 | 50 | 62 | 65 | 83 | 209 | 260 | |
| Interest | 20 | 24 | 22 | 30 | 22 | 34 | 31 | 28 | 95 | 115 | |
| Other Income | 5 | 8 | 4 | 44 | 1 | 8 | 4 | 47 | 61 | 60 | |
| PBT | 100 | 266 | 163 | 397 | 308 | 394 | 271 | 592 | 926 | 1,565 | |
| Tax | 27 | 82 | 48 | 57 | 85 | 106 | 73 | 163 | 214 | 423 | |
| Tax/PBT (%) | 27.1 | 30.9 | 29.2 | 14.4 | 27.5 | 27.0 | 27.0 | 27.5 | 23.1 | 27.0 | |
| Reported PAT | 73 | 184 | 115 | 340 | 223 | 288 | 198 | 429 | 712 | 1,142 | |
| Adjusted PAT | 73 | 184 | 115 | 340 | 223 | 288 | 198 | 429 | 712 | 1,142 | |
| Change (%) | 44.6 | 58.8 | 66.4 | 34.0 | 205.8 | 56.3 | 71.9 | 26.4 | 45.6 | 60.5 | |
| PAT Margin (%) | 2.3 | 4.9 | 3.1 | 6.3 | 4.8 | 5.5 | 3.8 | 5.8 | 4.4 | 5.1 | |

E: MOST Estimates

1QFY08 PAT up 206% YoY

Blue Star's 1QFY08 results are significantly above expectation. Revenue is up 48% YoY (expected 30%), EBITDA up 139% YoY and PAT up 206% YoY at Rs223m (expected Rs99m, up 35% YoY). EBITDA margin has expanded 300bp to 8.2%, led by (1) economies of scale, and (2) full benefit of excise-free room AC plant at Himachal Pradesh.

Segment analysis: Blue Star's performance was good across all the three business segments. EBIT growth and EBIT margin expansion was exceptionally pronounced in Cooling Products segment, reflecting:

- ✍ High demand for split ACs
- ✍ Good response for Blue Star's newly launched product variants such as mega and hiper splits
- ✍ Excise exemption at the Himachal Pradesh plant.

SEGMENT ANALYSIS (RS M)

| | 1QFY07 | 1QFY08 | YOY (%) | FY07 |
|-----------------------------|--------------|--------------|--------------|---------------|
| Segment income | 3,123 | 4,623 | 48.0 | 16,013 |
| Central AC | 1,864 | 2,770 | 48.7 | 11,243 |
| Cooling products | 1,118 | 1,583 | 41.6 | 3,728 |
| Prof. Electronics | 142 | 269 | 89.8 | 1,042 |
| Segment EBIT | 280 | 495 | 77.0 | 1,505 |
| Central AC | 176 | 281 | 60.0 | 1,052 |
| Cooling products | 94 | 165 | 75.2 | 251 |
| Prof. Electronics | 10 | 49 | 386.1 | 203 |
| Unallocable exps (net) | 160 | 165 | 3.5 | 484 |
| Total EBIT | 120 | 330 | 174.5 | 1,021 |
| Seg. EBIT Margin (%) | 9.0 | 10.7 | 1.8 | 9.4 |
| Central AC | 9.4 | 10.2 | 0.7 | 9.4 |
| Cooling products | 8.4 | 10.4 | 2.0 | 6.7 |
| Prof. Electronics | 7.1 | 18.2 | 11.1 | 19.4 |
| Total EBIT Margin (%) | 3.8 | 7.1 | 3.3 | 6.4 |

Source: Company/Motilal Oswal Securities

IT and retail/entertainment driving demand

Major orders booked during 1QFY08 confirm that Blue Star continues to benefit from at least two of our identified mega trends, IT/ITeS and retail/entertainment.

It bagged several multiple location orders during the quarter including from Infosys, Reliance Communications, Vishal Retail and Aditya Birla Retail.

BLUE STAR - 1QFY08 MAJOR ORDERS

| IT/ITES | RETAIL | OTHERS |
|---------------------------|---------------------------|------------------------|
| Infosys * | Vishal Retail * | Medicity, Gurgaon |
| Microsoft, Secunderabad | Aditya Birla Retail * | SunCity, Jaipur |
| Capgemini, Mumbai | Empress City Mall, Nagpur | HDFC Chubb, Mumbai |
| Reliance Communications * | Cosmos Mall, Siliguri | Tata Steel, Jamshedpur |

* Multiple locations

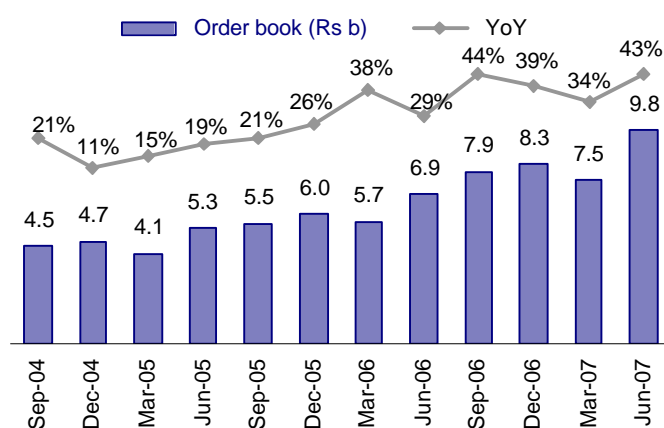
Source: Company/Motilal Oswal Securities

We believe benefits of other two mega trends – SEZs and cold chain – should accrue in the years to come. Currently, of the proposed 644 SEZs, 130 have obtained land, 341 have received formal approvals and another 171 have received in-principle approvals. In cold chains, a reported US\$1.2b investment in the pipeline by players like Reliance Retail, Cochin International Airport, etc.

Blue Star in high-growth orbit

Blue Star's carry forward order book as on 30 June 2007 stands at Rs9.8b, up 43% YoY. Our analysis of Blue Star's order book trend suggests that the company has moved into a high-growth orbit.

BLUE STAR – ORDER BOOK TREND



Source: Company/Motilal Oswal Securities

The company also plans to increase its business opportunity by building competencies to take up complete electro-mechanical projects. We expect Blue Star to gradually improve margins to double-digit levels, based on a combination of right project selection, judicious price hikes and value engineering.

Overall, we are convinced that the revenue and profit outlook for Blue Star is very positive.

20% upgrade in FY08 and FY09 EPS estimate

Considering Blue Star's 1QFY08 performance, outstanding order book and positive outlook, we have revised our FY08 income growth rate from 30% to 40%. This leads to a 60bp higher margin over our earlier estimates, and a 20% upgrade in our EPS estimate to Rs12.7 for FY08 and Rs17.5 for FY09. FY07-09 EPS CAGR is a robust 49%.

Sensitivity analysis: We believe Blue Star's earnings are most sensitive to revenue growth. Our sensitivity analysis to growth rates suggests that the average of most likely outcomes is the same as our base case EPS estimate for FY09.

FY09E EPS (RS) - SENSITIVITY TO GROWTH RATES

| | FY08 | 30% | 35% | 40% | 45% | 50% |
|-------------|------|------|------|------|------|-----|
| FY09 | | | | | | |
| 20% | 11.6 | 13.1 | 14.5 | 15.9 | 17.4 | |
| 25% | 13.0 | 14.5 | 16.0 | 17.5 | 19.0 | |
| 30% | 14.5 | 16.0 | 17.5 | 19.1 | 20.6 | |
| 35% | 15.9 | 17.5 | 19.1 | 20.7 | 22.3 | |
| 40% | 17.3 | 18.9 | 20.6 | 22.2 | 23.9 | |

Base case in grey; most likely outcomes boxed - average Rs17.5

Valuation and view

- ✍ At CMP of Rs275, the stock trades at a P/E of 21.7x FY08E and 15.7x FY09E.
- ✍ We believe the stock will continue to enjoy premium valuation considering the robust EPS CAGR of 49%, RoE and RoCE greater than 45%, and high payout ratio of 40%.
- ✍ We value Blue Star at 20x FY09E EPS to arrive at a target of Rs350, 27% upside from current levels.
- ✍ We maintain **Buy**.

Blue Star: an investment profile

Company description

Blue Star is India's leading central air-conditioning company with a market share of over 30%. Besides, it also makes a wide range of window and split ACs, and refrigeration products such as deep freezers, cold storages, water dispensers, visi-coolers, etc.

Key investment arguments

- Blue Star's products and services should see high demand from four mega trends: (1) IT/ITeS growth (2) Boom in retail and entertainment (3) SEZs, and (4) Expected large scale investment in cold chain.
- Blue Star has several national accounts (i.e. large all-India customers) with visible expansion plans. These include names like Infosys, Wipro, Bharti Airtel, DLF, Vishal Retail, Aditya Birla Retail, etc.
- The company has attained critical mass of cash flows to support its own growth and also manage healthy dividend payout of over 40% of profits.

Key investment risks

- Lower revenue growth due to slowdown in IT/ITeS, led by US recession and stronger rupee.
- Margin hit due to sharp increases in input prices such as copper and steel, affecting margins.

Recent development

- Blue Star announced the setting up of its fifth plant at Wada near Thane in Maharashtra. Spread over 35 acres, this plant is expected to meet most of Blue Star's future requirements. The company will be investing Rs350m in Phase 1, expected to go on stream by March 2008.

Valuation and view

- Valuation is rich at a P/E of 21.7x FY08E and 15.7x FY09E.
- We believe the stock will continue to enjoy premium valuation given high 49% EPS CAGR through FY09E, RoE and RoCE of over 45% and dividend payout of 40%.

Sector view

- The HVAC&R (heating, ventilating, air-conditioning and refrigeration equipment) sector is in a high-growth phase.
- Growth in central AC is led by demand from IT and retail sectors, while growth in room ACs is led by higher income levels and lifestyle aspirations.
- Investments in SEZs and cold chain are expected to keep the growth momentum strong over the next five years at least.

COMPARATIVE VALUATIONS

| | | BLUE STAR | VOLTAS |
|---------------|-------|-----------|--------|
| P/E (x) | FY08E | 21.7 | 26.1 |
| | FY09E | 15.7 | 19.5 |
| P/BV (x) | FY08E | 8.7 | 8.9 |
| | FY09E | 6.6 | 6.6 |
| EV/Sales (x) | FY08E | 1.2 | 1.4 |
| | FY09E | 0.9 | 1.1 |
| EV/EBITDA (x) | FY08E | 13.7 | 20.3 |
| | FY09E | 9.8 | 15.0 |

SHAREHOLDING PATTERN (%)

| | JUN-07 | MAR-07 | JUN-06 |
|---------------|--------|--------|--------|
| Promoter | 40.2 | 40.2 | 40.1 |
| Domestic Inst | 8.1 | 8.4 | 15.0 |
| Foreign | 8.6 | 8.4 | 2.5 |
| Others | 43.2 | 43.0 | 42.4 |

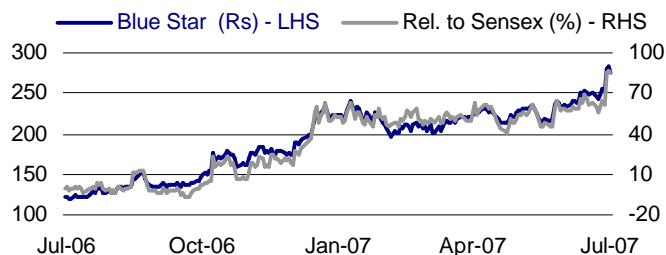
EPS: MOST FORECAST VS CONSENSUS (RS)

| | MOST FORECAST | CONSENSUS FORECAST | VARIATION (%) |
|------|---------------|--------------------|---------------|
| FY08 | 12.7 | 9.9 | 27.9 |
| FY09 | 17.5 | 16.5 | 5.9 |

TARGET PRICE AND RECOMMENDATION

| CURRENT PRICE (RS) | TARGET PRICE (RS) | UPSIDE (%) | RECO. |
|--------------------|-------------------|------------|-------|
| 275 | 350 | 27.3 | Buy |

STOCK PERFORMANCE (1 YEAR)



| INCOME STATEMENT | | (Rs Million) | | | | |
|-----------------------------|--------------|---------------|---------------|---------------|---------------|--|
| Y/E MARCH | 2005 | 2006 | 2007 | 2008E | 2009E | |
| Net Sales | 9,208 | 11,745 | 16,013 | 22,418 | 29,143 | |
| Change (%) | 32.0 | 27.6 | 36.3 | 30.0 | 30.0 | |
| Raw Materials | 7,170 | 9,079 | 12,427 | 17,486 | 22,732 | |
| % of Net Sales | 77.9 | 77.3 | 77.6 | 78.0 | 78.0 | |
| Staff Cost | 724 | 883 | 1,229 | 1,536 | 1,920 | |
| % of Net Sales | 7.9 | 7.5 | 7.7 | 6.9 | 6.6 | |
| Admin. & Other Exp. | 736 | 917 | 1,188 | 1,517 | 1,909 | |
| % of Net Sales | 8.0 | 7.8 | 7.4 | 6.8 | 6.5 | |
| EBITDA | 578 | 866 | 1,169 | 1,880 | 2,583 | |
| Change (%) | 45.4 | 49.9 | 34.9 | 60.8 | 37.4 | |
| Depreciation | 123 | 159 | 209 | 260 | 303 | |
| Interest | 32 | 57 | 95 | 115 | 104 | |
| Other Income | 47 | 41 | 61 | 60 | 70 | |
| Non Recurring Income | 55 | 0 | 0 | 0 | 0 | |
| PBT | 524 | 691 | 926 | 1,565 | 2,245 | |
| Tax (incl FBT and def. tax) | 132 | 202 | 214 | 423 | 674 | |
| Tax/PBT (%) | 25.3 | 29.2 | 23.1 | 27.0 | 30.0 | |
| Reported PAT | 392 | 489 | 712 | 1,142 | 1,572 | |
| Adjusted PAT | 351 | 489 | 712 | 1,142 | 1,572 | |
| Change (%) | 39.7 | 39.4 | 45.6 | 60.5 | 37.6 | |

| BALANCE SHEET | | (Rs Million) | | | | |
|--------------------------|--------------|--------------|--------------|--------------|---------------|--|
| Y/E MARCH | 2005 | 2006 | 2007 | 2008E | 2009E | |
| Net Worth | 1,484 | 1,727 | 2,130 | 2,830 | 3,770 | |
| Share Capital | 180 | 180 | 180 | 180 | 180 | |
| Reserves | 1,304 | 1,547 | 1,950 | 2,650 | 3,591 | |
| Total Debt | 373 | 759 | 890 | 1,027 | 712 | |
| Net Deferred Tax | 83 | 91 | 65 | 65 | 65 | |
| Capital Employed | 1,940 | 2,576 | 3,085 | 3,922 | 4,548 | |
| Gross Fixed Assets | 1,639 | 1,977 | 2,308 | 2,882 | 3,182 | |
| Capex | 290 | 377 | 244 | 600 | 300 | |
| Less: Acc. Depreciation | 873 | 1,010 | 1,167 | 1,427 | 1,730 | |
| Net Fixed Assets | 766 | 968 | 1,141 | 1,455 | 1,452 | |
| Capital WIP | 73 | 111 | 24 | 50 | 50 | |
| Investments | 52 | 52 | 53 | 53 | 53 | |
| Curr. Assets | 3,861 | 4,967 | 6,495 | 8,420 | 10,853 | |
| Inventory | 1,190 | 1,648 | 2,086 | 2,697 | 3,424 | |
| Debtors | 1,958 | 2,388 | 3,507 | 4,559 | 5,927 | |
| Cash & Bank | 25 | 24 | 46 | 50 | 55 | |
| Loans, Adv. & Others | 689 | 906 | 856 | 1,113 | 1,447 | |
| Curr. Liabilities | 2,856 | 3,553 | 4,650 | 6,068 | 7,860 | |
| Creditors | 932 | 1,531 | 1,896 | 2,624 | 3,393 | |
| Other Liabilities | 1,705 | 1,742 | 2,600 | 3,344 | 4,348 | |
| Provisions | 219 | 280 | 154 | 100 | 120 | |
| Net Curr. Assets | 1,005 | 1,413 | 1,845 | 2,352 | 2,993 | |
| Misc. Expenses | 44 | 33 | 22 | 12 | 0 | |
| Total Assets | 1,940 | 2,576 | 3,085 | 3,922 | 4,548 | |

E: Most Estimates

| RATIOS | | | | | | |
|--------------------------------|------------|------------|------------|-------------|-------------|--|
| Y/E MARCH | 2005 | 2006 | 2007 | 2008E | 2009E | |
| Basic (Rs) | | | | | | |
| EPS | 3.9 | 5.4 | 7.9 | 12.7 | 17.5 | |
| Cash EPS | 5.3 | 7.2 | 10.2 | 15.6 | 20.8 | |
| Book Value | 16.5 | 19.2 | 23.7 | 31.5 | 41.9 | |
| Dividend per share | 2.0 | 2.4 | 3.0 | 4.2 | 6.0 | |
| Payout incl. Div. Tax. (%) | 50.6 | 49.9 | 42.8 | 38.7 | 40.2 | |
| Valuation (x) | | | | | | |
| P/E | | 50.6 | 34.7 | 21.7 | 15.7 | |
| Cash P/E | | 38.1 | 26.9 | 17.6 | 13.2 | |
| Price/Book Value | | 14.3 | 11.6 | 8.7 | 6.6 | |
| EV/Sales | | 2.2 | 1.6 | 1.2 | 0.9 | |
| EV/EBITDA | | 29.4 | 21.9 | 13.7 | 9.8 | |
| Dividend Yield (%) | | 0.9 | 1.1 | 1.5 | 2.2 | |
| Profitability (%) | | | | | | |
| RoE | 28.1 | 30.5 | 36.9 | 46.1 | 47.6 | |
| RoCE | 29.0 | 33.1 | 36.1 | 47.9 | 55.5 | |
| Turnover Ratios | | | | | | |
| Debtors (days of sales) | 78 | 74 | 80 | 80 | 80 | |
| Inventory (days of sales) | 47 | 51 | 48 | 47 | 46 | |
| Creditors (days of total exp.) | 39 | 51 | 47 | 47 | 47 | |
| Asset Turnover (x) | 4.7 | 4.6 | 5.2 | 5.7 | 6.4 | |
| Leverage Ratio | | | | | | |
| Debt/Equity (x) | 0.3 | 0.4 | 0.4 | 0.4 | 0.2 | |

| CASH FLOW STATEMENT | | (Rs Million) | | | | |
|--------------------------------|-------------|--------------|-------------|--------------|---------------|--|
| Y/E MARCH | 2005 | 2006 | 2007 | 2008E | 2009E | |
| PBT excl. EO Items | 469 | 691 | 926 | 1,565 | 2,245 | |
| Add: Depn & Amortization | 122 | 171 | 219 | 270 | 316 | |
| Interest Paid | 32 | 57 | 95 | 115 | 104 | |
| Less: Direct Taxes Paid | -132 | -202 | -214 | -423 | -674 | |
| (Incr)/Decr in WC | -233 | -409 | -409 | -503 | -636 | |
| CF from Operations | 258 | 308 | 617 | 1,024 | 1,356 | |
| Extraordinary Items | 55 | 0 | 0 | 0 | 0 | |
| CF including EO Items | 313 | 308 | 617 | 1,024 | 1,356 | |
| (Incr)/Decr in FA | -313 | -399 | -295 | -600 | -300 | |
| (Pur)/Sale of Investments | 3 | 0 | -1 | 0 | 0 | |
| CF from Inv. Activity | -310 | -399 | -296 | -600 | -300 | |
| Incr/(Decr) in Net worth | 0 | -2 | 0 | 0 | 0 | |
| Incr/(Decr) in Debt | 235 | 394 | 106 | 137 | -315 | |
| Interest Paid | -32 | -57 | -95 | -115 | -104 | |
| Dividend Paid (incl. div. tax) | -205 | -244 | -309 | -442 | -631 | |
| CF from Fin. Activity | -3 | 90 | -298 | -420 | -1,051 | |
| Incr/(Decr) of Cash | 1 | -1 | 22 | 4 | 5 | |
| Add: Opening Balance | 24 | 25 | 24 | 46 | 50 | |
| Closing Balance | 25 | 24 | 46 | 50 | 55 | |



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Blue Star

- | | |
|---|----|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with company covered | No |

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