



IDFC

STOCK INFO. BLOOMBERG  
BSE Sensex: 13,024 IDFC IN  
REUTERS CODE  
S&P CNX: 3,769 IDFC.BO

30 October 2006

Buy

Rs82

Previous Recommendation: Buy

|                     |          |
|---------------------|----------|
| Equity Shares (m)   | 1,122.5  |
| 52-Week Range       | 83/43    |
| 1,6,12 Rel.Perf.(%) | 17/4/-39 |
| M.Cap. (Rs b)       | 92.4     |
| M.Cap. (US\$ b)     | 2.0      |

| YEAR END | NET INCOME (RS M) | PAT (RS M) | EPS (RS) | EPS GROWTH (%) | P/E (X) | P/BV (X) | CAR (%) | ROE (%) | ROA (%) | P/ABV (X) |
|----------|-------------------|------------|----------|----------------|---------|----------|---------|---------|---------|-----------|
| 3/06A    | 5,149             | 3,756      | 3.3      | 10.1           | 24.6    | 3.6      | 25.6    | 16.9    | 3.6     | 3.6       |
| 3/07E    | 7,088             | 4,832      | 4.3      | 28.6           | 19.1    | 3.2      | 21.5    | 17.7    | 3.3     | 3.2       |
| 3/08E    | 8,793             | 5,735      | 5.1      | 18.7           | 16.1    | 2.8      | 18.0    | 18.3    | 2.9     | 2.8       |

IDFC has posted 35% (standalone) increase in earnings YoY to Rs1.4b on the back of improving margins and strong disbursements. Business momentum has remained robust with disbursements up 44% in 1HFY07. IDFC continues to maintain its asset quality, with nil net NPLs.

- ✍ NII from infrastructure loans grows by 38% YoY, excluding one-offs
- ✍ Maintains strong growth in disbursals
- ✍ Margins improving on back of improving asset yields
- ✍ Higher treasury profits; fee income growth strong

The current performance demonstrates strong loan growth and management is extremely optimistic with respect to future growth prospects. Margins are also likely to stabilize as asset yields have also been increasing in line with the rise in borrowing costs. Further IDFC is building up a steady pipeline of fee income. With asset quality remaining robust and management clarifying on writeback of additional provisions being held, we are lowering our provisioning requirement for FY07 and FY08. We have revised our earnings numbers upward by 16% for FY07 and by 13% for FY08. We now expect EPS of Rs4.3 in FY07 and Rs5.1 in FY08. IDFC currently trades at 2.8x FY08E BV. We maintain our **Buy** recommendation on our target price of Rs90 (valuing IDFC at 3x FY08E BV).

| Y/E MARCH                     | (RS MILLION) |              |              |              |              |              |               |               |
|-------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|---------------|---------------|
|                               | FY06         |              |              |              | FY07         |              | FY06*         | FY07E*        |
|                               | 1Q           | 2Q           | 3Q           | 4Q           | 1Q           | 2Q           |               |               |
| Operating Income              | 2,562        | 2,577        | 2,446        | 2,553        | 3,211        | 3,863        | 10,138        | 15,454        |
| Other Income                  | 1            | 0            | 3            | 14           | 6            | 13           | 19            | 80            |
| <b>Total income</b>           | <b>2,564</b> | <b>2,577</b> | <b>2,449</b> | <b>2,567</b> | <b>3,218</b> | <b>3,876</b> | <b>10,157</b> | <b>15,534</b> |
| Y-o-Y Growth (%)              | 85.0         | 60.5         | 37.9         | 2.3          | 25.5         | 50.4         | 39.6          | 52.9          |
| Interest expenses             | 1,117        | 1,163        | 1,314        | 1,415        | 1,643        | 1,960        | 5,008         | 8,447         |
| <b>Net Income</b>             | <b>1,447</b> | <b>1,415</b> | <b>1,135</b> | <b>1,152</b> | <b>1,574</b> | <b>1,916</b> | <b>5,149</b>  | <b>7,088</b>  |
| Operating Expenses            | 68           | 91           | 86           | 161          | 102          | 149          | 406           | 519           |
| <b>Operating Profit</b>       | <b>1,379</b> | <b>1,324</b> | <b>1,049</b> | <b>992</b>   | <b>1,472</b> | <b>1,766</b> | <b>4,743</b>  | <b>6,569</b>  |
| Y-o-Y Growth (%)              | 138.7        | 56.0         | 17.1         | -37.7        | 6.8          | 33.4         | 21.2          | 38.5          |
| Depreciation                  | 8            | 8            | 9            | 10           | 10           | 10           | 34            | 36            |
| Provisions                    | 204          | 169          | 10           | 132          | 0            | -25          | 516           | 350           |
| <b>Profit before Tax</b>      | <b>1,167</b> | <b>1,147</b> | <b>1,030</b> | <b>850</b>   | <b>1,462</b> | <b>1,781</b> | <b>4,193</b>  | <b>6,183</b>  |
| Tax Provisions                | 84           | 103          | 136          | 114          | 250          | 367          | 437           | 1,351         |
| <b>Net Profit</b>             | <b>1,083</b> | <b>1,044</b> | <b>894</b>   | <b>736</b>   | <b>1,212</b> | <b>1,414</b> | <b>3,756</b>  | <b>4,832</b>  |
| Y-o-Y Growth (%)              | 112.9        | 39.5         | 11.4         | -54.8        | 12.0         | 35.4         | 23.6          | 28.6          |
| Int Exp/ Int Earned (%)       | 43.6         | 45.1         | 53.7         | 55.4         | 51.2         | 50.7         | 49.4          | 54.7          |
| Other Income / Net Income (%) | 0.1          | 0.0          | 0.3          | 1.2          | 0.4          | 0.7          | 0.4           | 1.1           |
| Cost to Income Ratio (%)      | 4.7          | 6.4          | 7.6          | 13.9         | 6.5          | 7.8          | 7.9           | 7.3           |

E: MOST Estimates \* Quarterly nos and full year nos will not tally due to different way of reporting financial nos

IDFC has posted 35% (standalone) increase in earnings YoY to Rs1.4b on the back of improving margins and strong disbursements. Business momentum has remained robust with disbursements up 44% in 1HFY07. IDFC continues to maintain its asset quality, with nil net NPLs.

### **NII from Infrastructure loans grows 38% YoY, excluding one-off**

NII on infrastructure loans (consolidated; excluding a one-off of Rs150m) has increased by 38% YoY in 1HFY07 to Rs1.9b and by 17% in 2QFY07, as asset yields have improved and disbursements have been strong during the quarter. Infrastructure NII's share in total income has risen to 52% in 1HFY07 from 49% in 1HFY06, although the same is down to 43% in 2QFY07 from 54% in 2QFY06.

### **Disbursals maintain strong growth**

Strong growth in balance sheet parameters has been maintained. Gross disbursements have increased 44% during 1HFY07 to Rs34.4b. Loan book has expanded by 49% to Rs123b. However, gross approvals have increased by just 1% YoY to Rs63b. Management has indicated that besides the gap in sanctions (exposure) and disbursements, which is close to Rs61b, it also has a strong pipeline of new loan requests over the next few quarters.

### **Margins better on back of improving asset yields**

Improving asset yields have resulted in margins being maintained QoQ. Infrastructure asset yields (excluding one-off) have increased to 9.1% in 1HFY07 from 9.0% in 1HFY06. Overall yields (including treasury yields) have also improved to 8.9% in 1HFY07 from 8.7% in 1HFY06 on back of significant improvement in treasury yields (up by 130bp YoY). Management has stated that the margins which are around ~3.0% would tend to stabilize at these levels going forward with improving asset yields, despite slight pressure on incremental funding costs.

### **Higher Treasury profits; Fee income growth strong**

IDFC has booked equity gains out of its proprietary equity book to the tune of Rs610m during the quarter compared with Rs410m witnessed during 2QFY06. Compared with previous quarters, treasury gains have improved. As of September 2006, IDFC had unrealized gains valued at Rs1.6b on its books, which have declined from the June 2006 level of Rs1.9b.

IDFC's fee income YoY has increased by 87% YoY to Rs280m in 2QFY07 (Rs540m in 1HFY07 compared with Rs380m in 1HFY06) versus Rs150m in 2QFY06. Of this, Rs130m arose from the asset management business in 2QFY07 (Rs280m in 1HFY07) and the balance was fees from core operations and other miscellaneous income.

Management has indicated that in the coming quarters, fee income is likely to increase as its recent tie-ups/JVs/MOUs with SSKI, Feedback, SBI Caps amongst others would result in higher fee income. Also, with its subsidiaries (IDFC AMC and IDFC Private Equity) growing bigger, we expect fee-based income to constitute a larger chunk of the total income pie.

### **Tax rate increases**

IDFC's tax rate has increased to ~21% in 2QFY07 from 9% in 2QFY06. This is in line with what management had stated earlier that withdrawal of 10(23)G and increasing share of fee income in total income is resulting in increase in tax rates.

### **Maintains a stringent policy than required**

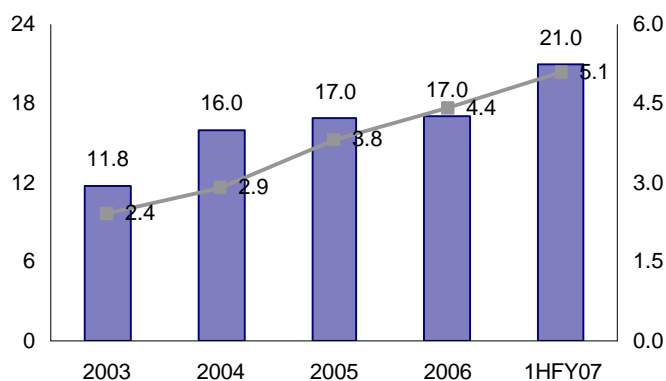
Standard asset provisions have continued to increase in line with increase in asset base. IDFC follows a policy of providing 0.5% of gross disbursements against a norm of 0.4% on assets outstanding. However, on its books, IDFC carries additional provisions, which management mentioned they would be writing back over the next few quarters. As a result, we are now assuming much lower provisioning for FY07 and FY08 compared with our earlier assumptions.

### RoA at 3.6%

Ahead of our expectations, IDFC has been able to sustain its RoA at 3.6% (12-month trailing) compared with 3.7% as of June 2006 (12-month trailing) despite higher leverage. This is due to stable-to-improving NIMs as well as relatively higher contribution from non-interest income. Also, provisioning, has remained low for IDFC. Leverage has increased to 5.1x from 4.1x, a year ago. Going forward, we expect RoA to decline on the back of increasing leverage coupled with lower contribution from treasury. However RoE will tend to increase as IDFC improves its leverage.

The current capital adequacy ratio (CAR) for IDFC is 23%, of which Tier 1 is ~17%, indicating that it can support strong 35%-40% growth in loans over the next couple of years. Further, management has indicated that with leverage at only 5.1x, CAR can go up to ~8x before requiring another tranche of capital.

IMPROVING LEVERAGE, IMPROVING ROE



Source: Company / Motilal Oswal Securities

### Earnings grow 46% on consolidated basis; 35% on standalone basis

On the back of strong growth in NII and improved margins, IDFC has posted PAT growth of 46% for 2QFY07 at Rs1.55b. On a standalone basis, PAT growth has been 35% YoY to Rs1.4b in 2QFY07. Net NPAs continued to be nil, with gross NPAs at 0.2% (decline from 0.6% in 1HFY06).

### We maintain Buy

The current performance demonstrates strong loan growth and management is extremely optimistic on future growth prospects. Margins are also likely to stabilize as asset yields have also been increasing in line with the rise in borrowing costs. Further IDFC is building up a steady pipeline of fee income. With asset quality remaining robust and management clarifying on writeback of additional provisions being held, we are lowering our provisioning requirement for FY07 and FY08. We have revised our earnings numbers upward by 16% for FY07 and by 13% for FY08. We now expect EPS of Rs4.3 in FY07 and Rs5.1 in FY08. IDFC currently trades at 2.8x FY08E BV. We maintain our **Buy** recommendation on our target price of Rs90 (valuing IDFC at 3x FY08E BV).

## IDFC: an investment profile

### Company description

IDFC was established in 1997 as a specialized financial intermediary to catalyze private sector investments to commercially viable infrastructure projects. Apart from infrastructure funding, IDFC works closely with the GoI and other state governments to conceptualize and formulate policies that will inculcate a conducive environment for private sector participation in the infrastructure sector. IDFC's main focus areas are power, roads, ports and telecom. Since the time IDFC began operations in 1997, it has rapidly grown across all business parameters. While its total assets, total income and profit after tax have recorded CAGR of 33%, 21% and 22% respectively, total infrastructure loans have grown at an impressive CAGR of 54% from FY01 to FY06.

### Key investment arguments

- ✍ Explosive infrastructure growth will enable robust loan book expansion and fee income growth
- ✍ The company has a sterling pedigree in quality lending, and hence is able to maintain zero net NPAs
- ✍ Enjoys the highest RoA in the sector; high CAR gives enough room to grow loan book and boost RoE
- ✍ Is one of the few US\$2b stocks in the financial sector available to FIIs

### COMPARATIVE VALUATIONS

|           |       | IDFC | HDFC | HDFC BANK |
|-----------|-------|------|------|-----------|
| P/E (x)   | FY07E | 19.1 | 24.0 | 28.2      |
|           | FY08E | 16.1 | 19.9 | 21.7      |
| P/ABV (x) | FY07E | 3.2  | 6.8  | 5.2       |
|           | FY08E | 2.8  | 5.6  | 4.3       |
| RoE (%)   | FY07E | 17.7 | 30.6 | 19.7      |
|           | FY08E | 18.3 | 30.2 | 21.5      |
| RoA (%)   | FY07E | 3.3  | 2.6  | 1.3       |
|           | FY08E | 2.9  | 2.5  | 1.3       |

### SHAREHOLDING PATTERN (%)

|               | SEP.06 | JUN.06 | SEP.05 |
|---------------|--------|--------|--------|
| Promoter      | 0.0    | 0.00   | 0.0    |
| Domestic Inst | 40.9   | 42.9   | 44.8   |
| Foreign       | 45.9   | 43.5   | 41.7   |
| Others        | 13.2   | 13.6   | 13.5   |

### Key investment risks

- ✍ Is dependent on government policies
- ✍ Rising interest rates may pressurize margins
- ✍ Faces competitive pressures from banks

### Recent developments

- ✍ IDFC board has approved of increasing the FII limit in the equity share capital of the company from 24% to 49% of the paid-up equity capital of the company
- ✍ The board has also approved to offer, issue and allot in one or more tranches and in one or more private or preferential offerings, an aggregate value of up to US\$250m or its equivalent

### Valuation and view

- ✍ With the growth in infrastructure development activities, the loan book is expected to expand by 40% CAGR in FY06-09E. The borrowings will also grow at 43% CAGR during the same period.
- ✍ PAT is expected to grow by 29% in FY07 and 19% in FY08. The stock trades at P/BV of 2.8x FY08E BV. We recommend **Buy** with the price target of Rs90

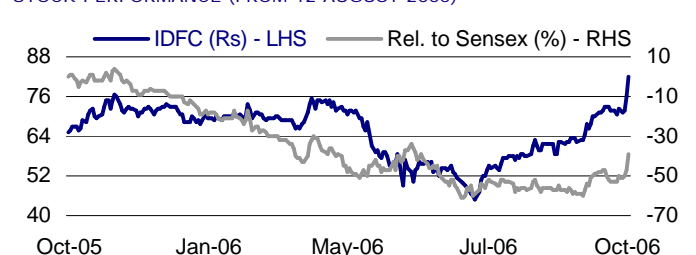
### EPS: MOST FORECAST VS CONSENSUS (RS)

|      | MOST FORECAST | CONSENSUS FORECAST | VARIATION (%) |
|------|---------------|--------------------|---------------|
| FY07 | 4.3           | 4.2                | 2.2           |
| FY08 | 5.1           | 5.0                | 1.2           |

### TARGET PRICE AND RECOMMENDATION

| CURRENT PRICE (RS) | TARGET PRICE (RS) | UPSIDE (%) | RECO. |
|--------------------|-------------------|------------|-------|
| 82                 | 90                | 9.4        | Buy   |

### STOCK PERFORMANCE (FROM 12 AUGUST 2005)



**INCOME STATEMENT (RS MILLION)**

| Y/E MARCH                  | 2005         | 2006         | 2007E        | 2008E        | 2009E         |
|----------------------------|--------------|--------------|--------------|--------------|---------------|
| Interest Income            | 5,481        | 7,741        | 12,313       | 17,952       | 24,591        |
| Interest Expended          | 3,19         | 5,008        | 8,447        | 12,766       | 17,806        |
| <b>Net Interest Income</b> | <b>2,362</b> | <b>2,733</b> | <b>3,866</b> | <b>5,186</b> | <b>6,785</b>  |
| Change (%)                 | 22.1         | 15.7         | 415          | 34.1         | 30.8          |
| Other Income               | 1,795        | 2,416        | 3,221        | 3,607        | 3,961         |
| <b>Net Income</b>          | <b>4,157</b> | <b>5,149</b> | <b>7,088</b> | <b>8,793</b> | <b>10,746</b> |
| Change (%)                 | 1.1          | 23.9         | 37.6         | 24.1         | 22.2          |
| Operating Expenses         | 280          | 440          | 555          | 670          | 817           |
| <b>Operating Income</b>    | <b>3,878</b> | <b>4,709</b> | <b>6,533</b> | <b>8,122</b> | <b>9,929</b>  |
| Change (%)                 | 2.0          | 2.14         | 38.7         | 24.3         | 22.2          |
| Other Provisions           | 648          | 516          | 350          | 600          | 750           |
| <b>PBT</b>                 | <b>3,230</b> | <b>4,193</b> | <b>6,183</b> | <b>7,522</b> | <b>9,179</b>  |
| Tax                        | 190          | 437          | 1,351        | 1,788        | 2,275         |
| Tax Rate (%)               | 5.9          | 10.4         | 21.8         | 23.8         | 24.8          |
| <b>PAT</b>                 | <b>3,040</b> | <b>3,756</b> | <b>4,832</b> | <b>5,735</b> | <b>6,904</b>  |
| Change (%)                 | 17.3         | 23.6         | 28.6         | 18.7         | 20.4          |
| Proposed Dividend          | 1,143        | 1,283        | 1,122        | 1,403        | 1,684         |

**BALANCE SHEET (RS MILLION)**

| Y/E MARCH                 | 2005          | 2006           | 2007E          | 2008E          | 2009E          |
|---------------------------|---------------|----------------|----------------|----------------|----------------|
| Capital                   | 10,000        | 11,225         | 11,225         | 11,225         | 11,225         |
| Reserves & Surplus        | 8,889         | 14,217         | 17,927         | 22,258         | 27,479         |
| <b>Net Worth</b>          | <b>18,889</b> | <b>25,442</b>  | <b>29,151</b>  | <b>33,483</b>  | <b>38,703</b>  |
| <b>Borrowings</b>         | <b>58,951</b> | <b>87,165</b>  | <b>126,390</b> | <b>183,265</b> | <b>256,572</b> |
| Change (%)                | 77.3          | 47.9           | 45.0           | 45.0           | 40.0           |
| Sub-ordinated Debt        | 6,500         | 6,500          | 6,500          | 6,500          | 6,500          |
| Other Liabilities & Prov. | 2,975         | 4,447          | 5,337          | 6,671          | 8,339          |
| <b>Total Liabilities</b>  | <b>87,315</b> | <b>123,555</b> | <b>167,378</b> | <b>229,919</b> | <b>310,113</b> |
| Cash and bank balance     | 4,270         | 3,349          | 2,319          | 990            | 1,462          |
| Investments               | 7,688         | 12,949         | 14,891         | 17,869         | 21,443         |
| Change (%)                | -34.0         | 68.4           | 15.0           | 20.0           | 20.0           |
| <b>Advances</b>           | <b>70,504</b> | <b>101,834</b> | <b>144,604</b> | <b>205,338</b> | <b>281,312</b> |
| Change (%)                | 59.6          | 44.4           | 42.0           | 42.0           | 37.0           |
| Net Fixed Assets          | 505           | 498            | 512            | 524            | 534            |
| Deferred Tax Assets       | 662           | 792            | 713            | 642            | 577            |
| Other Assets              | 3,687         | 4,133          | 4,340          | 4,557          | 4,785          |
| <b>Total Assets</b>       | <b>87,315</b> | <b>123,555</b> | <b>167,378</b> | <b>229,919</b> | <b>310,113</b> |

**ASSUMPTIONS (%)**

|                    |       |      |      |      |      |
|--------------------|-------|------|------|------|------|
| Borrowings Growth  | 77.3  | 47.9 | 45.0 | 45.0 | 40.0 |
| Advances Growth    | 59.6  | 44.4 | 42.0 | 42.0 | 37.0 |
| Investments Growth | -34.0 | 68.4 | 15.0 | 20.0 | 20.0 |
| Dividend           | 10.0  | 10.0 | 10.0 | 12.5 | 15.0 |

E: MOST Estimates

**RATIOS**

| Y/E MARCH                   | 2005 | 2006 | 2007E | 2008E | 2009E |
|-----------------------------|------|------|-------|-------|-------|
| <b>Spreads Analysis (%)</b> |      |      |       |       |       |
| Avg. Yield - Earning Asset: | 7.7  | 7.5  | 8.7   | 9.3   | 9.3   |
| Avg. Cost-Int. Bear. Liab.  | 5.9  | 6.3  | 7.5   | 7.9   | 7.9   |
| Interest Spread             | 1.8  | 1.2  | 1.2   | 1.4   | 1.4   |
| Net Interest Margin         | 3.3  | 2.6  | 2.7   | 2.7   | 2.6   |

**Profitability Ratios (%)**

|                           |      |      |      |      |      |
|---------------------------|------|------|------|------|------|
| RoE                       | 16.9 | 16.9 | 17.7 | 18.3 | 19.1 |
| RoA                       | 4.1  | 3.6  | 3.3  | 2.9  | 2.6  |
| Int. Expended/Int. Earned | 56.9 | 64.7 | 68.6 | 71.1 | 72.4 |
| Other Inc./Net Income     | 43.2 | 46.9 | 45.5 | 41.0 | 36.9 |

**Efficiency Ratios (%)**

|                        |      |       |       |       |       |
|------------------------|------|-------|-------|-------|-------|
| Op. Exps./Net Income   | 6.7  | 8.6   | 7.8   | 7.6   | 7.6   |
| Empl. Cost/Op. Exps.   | 52.7 | 59.6  | 62.5  | 63.5  | 63.5  |
| Busi. per Empl. (Rs m) | 995  | 1,274 | 1,704 | 2,228 | 2,877 |
| NP per Empl. (Rs m)    | 29.2 | 30.1  | 35.8  | 38.7  | 42.9  |

**Asset-Liability Profile (%)**

|                       |      |       |       |       |       |
|-----------------------|------|-------|-------|-------|-------|
| Adv./Deposit Ratio    | 19.6 | 116.8 | 114.4 | 112.0 | 109.6 |
| Invest./Deposit Ratio | 13.0 | 14.9  | 11.8  | 9.8   | 8.4   |
| Gross NPAs to Adv.    | 0.7  | 0.5   | 0.7   | 0.8   | 0.8   |
| Net NPAs to Adv.      | 0.0  | 0.0   | 0.2   | 0.3   | 0.4   |
| CAR                   | 28.6 | 25.6  | 21.5  | 18.0  | 17.0  |
| Tier 1                | 20.1 | 19.2  | 15.0  | 12.0  | 12.0  |

**VALUATION**

|                    |      |      |      |      |      |
|--------------------|------|------|------|------|------|
| Book Value (Rs)    | 18.9 | 22.7 | 26.0 | 29.8 | 34.5 |
| Price-BV (x)       | 4.4  | 3.6  | 3.2  | 2.8  | 2.4  |
| Adjusted BV (Rs)   | 18.9 | 22.7 | 25.8 | 29.5 | 33.8 |
| Price-ABV (x)      | 4.4  | 3.6  | 3.2  | 2.8  | 2.4  |
| EPS (Rs)           | 3.0  | 3.3  | 4.3  | 5.1  | 6.2  |
| EPS Growth (%)     | 17.3 | 10.1 | 28.6 | 18.7 | 20.4 |
| Price-Earnings (x) | 27.1 | 24.6 | 19.1 | 16.1 | 13.4 |
| OPS (Rs)           | 3.9  | 4.2  | 5.8  | 7.2  | 8.8  |
| OPS Growth (%)     | 2.0  | 8.2  | 38.7 | 24.3 | 22.2 |
| Price-OP (x)       | 21.2 | 19.6 | 14.1 | 11.4 | 9.3  |

E: MOST Estimates

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|---|-------------|
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| 2. Group/Directors ownership of the stock               | No          |
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