

# Busy hiring

## Raising estimates & PO, Reiterate Buy

Post aggressive hiring in 4Q, bullish commentary on growth in the next couple of years and lower tax outlook post transfer pricing study, we raise FY08 and FY09 EPS estimates by 4% and 7% and up our PO by 11% to Rs105. Over FY07-09 we forecast strong 50% PAT & 38% EPS CAGR (post IPO dilution). Reiterate Buy; one of our top 2 mid-cap picks.

## Strong growth in 4Q; Beats MLE on tax; Controlled attrition

In line strong 4Q revenues growth of 29% qoq, 67% yoy with organic growth of 16% qoq, 51% yoy. EBITDA up 30% qoq, 51% yoy with margin expansion of 33bps. Margins lower than MLE due to initial costs on Hutch ramp. FY07 attrition (post 3m) at 42%, lower than Wipro BPO at 60% and WNS at 43% (post 6m). PAT +16% qoq, 61% yoy beating MLE by 26% due to lower taxes & forex gains.

## Record employee adds, 4Q hiring exceeds 9m hiring

Management guided for strong FY08 revenue growth of 50%, led by strength in telecom/media and collections. The Hutch account, which ramped in 4QFY07 and this quarter, is a 4,000+ person account, as per our estimate. 4Q hiring was a record 3,300 organic additions, higher than 2,367 employee adds in 9m.

## Attractive valuation; Visible growth, expanding margins

Our PO is at 22x FY09E PE at a PEG of 0.9 and current FY08E PE of 25x. Firstsource, an ICICI group company, is a play on rapid growth in offshoring of Business Process Outsourcing. It is the third-largest standalone Indian BPO vendor, where we forecast 44% revenue growth over the next two years. We estimate 247bps EBIT margin expansion on improving mix and operating leverage. Q1 FY08 likely to be seasonally weak due to wage hike and client ramp costs.

### Estimates (Mar)

(Rs)	2006A	2007A	2008E	2009E	2010
Net Income (Adjusted - mn)	247	972	1,521	2,195	NA
EPS	0.796	2.50	3.30	4.76	NA
EPS Change (YoY)	15.9%	213.9%	32.0%	44.3%	NA
Dividend / Share	0	0	0.716	1.03	NA
Free Cash Flow / Share	(1.11)	(0.907)	1.90	5.57	NA

### Valuation (Mar)

	2006A	2007A	2008E	2009E	2010
P/E	103.17x	32.87x	24.90x	17.25x	NA
Dividend Yield	0%	0%	0.872%	1.26%	NA
EV / EBITDA*	42.39x	20.60x	13.12x	9.52x	NA
Free Cash Flow Yield*	-0.639%	-0.689%	2.32%	6.79%	NA

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 8.



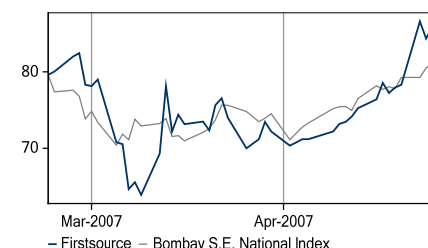
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### Stock Data

Price	Rs82.10
Price Objective	Rs95.00 to Rs105.00
Date Established	27-Apr-2007
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	Rs61.55-Rs91.20
Mrkt Val / Shares Out (mn)	US\$853 / 425.0
Average Daily Volume	1,210,575
ML Symbol / Exchange	FSSOF / BSE
Bloomberg / Reuters	FSOL IN / FISO.BO
ROE (2008E)	13.5%
Net Dbt to Eqty (Mar-2007A)	-9.7%
Est. 5-Yr EPS / DPS Growth	35.0% / 35.0%
Free Float	70.0%



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Refer to important disclosures on page 9 to 10. Analyst Certification on page 7. Price Objective Basis/Risk on page 7.

28 April 2007

# *iQprofile*<sup>SM</sup> Firstsource Solutions Ltd.

## Key Income Statement Data (Mar)

(Rs Millions)	2006A	2007A	2008E	2009E	2010
Sales	5,487	8,298	12,820	17,240	NA
Gross Profit	799	1,644	2,581	3,556	NA
Sell General & Admin Expense	NA	NA	NA	NA	NA
Operating Profit	347	1,002	1,702	2,508	NA
Net Interest & Other Income	(78)	24	96	150	NA
Associates	NA	NA	NA	NA	NA
Pretax Income	270	1,026	1,799	2,657	NA
Tax (expense) / Benefit	(27)	(60)	(268)	(450)	NA
Net Income (Adjusted)	247	972	1,521	2,195	NA
Average Fully Diluted Shares Outstanding	310	389	461	461	NA

## Key Cash Flow Statement Data

Net Income (Reported)	247	972	1,521	2,195	NA
Depreciation & Amortization	452	642	878	1,048	NA
Change in Working Capital	(329)	(693)	(591)	(176)	NA
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	2	(7)	0	0	NA
Cash Flow from Operations	371	914	1,809	3,068	NA
Capital Expenditure	(594)	(1,154)	(1,000)	(700)	NA
(Acquisition) / Disposal of Investments	(73)	(1,837)	0	0	NA
Other Cash Inflow / (Outflow)	14	(1,055)	0	0	NA
Cash Flow from Investing	(653)	(4,046)	(1,000)	(700)	NA
Shares Issue / (Repurchase)	16	5,400	0	0	NA
Cost of Dividends Paid	0	0	0	(295)	NA
Cash Flow from Financing	183	5,049	(1,781)	(573)	NA
Free Cash Flow	(223)	(240)	809	2,368	NA
Net Debt	1,130	(1,034)	(1,381)	(3,155)	NA
Change in Net Debt	353	(2,147)	(642)	(1,905)	NA

## Key Balance Sheet Data

Property, Plant & Equipment	1,154	1,802	1,924	1,576	NA
Other Non-Current Assets	4,076	6,578	6,578	6,578	NA
Trade Receivables	1,007	1,364	2,250	3,062	NA
Cash & Equivalents	170	3,010	1,742	3,406	NA
Other Current Assets	457	1,306	1,306	1,306	NA
Total Assets	6,865	14,060	13,799	15,928	NA
Long-Term Debt	1,300	1,976	361	251	NA
Other Non-Current Liabilities	0	7	7	7	NA
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	1,191	1,369	1,497	1,967	NA
Total Liabilities	2,491	3,351	1,865	2,224	NA
Total Equity	4,373	10,708	11,935	13,703	NA
Total Equity & Liabilities	6,865	14,060	13,799	15,928	NA

## *iQmethod*<sup>SM</sup> - Bus Performance\*

Return On Capital Employed	5.9%	10.8%	12.7%	16.9%	NA
Return On Equity	5.9%	13.0%	13.5%	17.2%	NA
Operating Margin	6.3%	12.1%	13.3%	14.5%	NA
EBITDA Margin	14.6%	19.8%	20.1%	20.6%	NA

## *iQmethod*<sup>SM</sup> - Quality of Earnings\*

Cash Realization Ratio	1.5x	0.9x	1.2x	1.4x	NA
Asset Replacement Ratio	1.3x	1.8x	1.1x	0.7x	NA
Tax Rate (Reported)	10.0%	5.9%	14.9%	16.9%	NA
Net Debt-to-Equity Ratio	25.8%	-9.7%	-11.6%	-23.0%	NA
Interest Cover	4.1x	12.9x	24.4x	NM	NA

## Key Metrics

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 8.

## Company Description

Firstsource, an ICICI group company, is the 5th largest India-centric Business Process Outsourcing vendor (FY06). Set up in Dec-01, it has complemented organic growth with inorganic initiatives. It offers transaction processing, collections management & customer acquisition/customer care services in Banking & Financial Services (abt 50% rev), Media & Telecom (abt 30% rev) & Healthcare (abt 15% rev) verticals. US & UK form abt 50% of revenue each.

## Stock Data

Price to Book Value	2.9x
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## Financial tables

**Table 1: Firstsource Q4FY07 snapshot**

Profit and Loss statement (Rs 'mn)	Q4FY07	Q3FY07	QoQ	Q4FY06	YoY	ML est	Variation
Revenue	2684	2082	28.9%	1611	66.6%	2603	3.1%
Other operating revenue (eg Grant)	63	66	-4.1%	0		82	
<b>Operating Revenue</b>	<b>2747</b>	<b>2148</b>	<b>27.9%</b>	<b>1611</b>	<b>70.6%</b>	<b>2685</b>	<b>2.3%</b>
Operating costs	697	691	0.8%	473	47.2%	847	-17.7%
Personnel	1498	1032	45.1%	772	94.1%	1264	18.5%
<b>EBITDA- ex forex</b>	<b>552</b>	<b>425</b>	<b>30.0%</b>	<b>366</b>	<b>51.0%</b>	<b>574</b>	<b>-3.8%</b>
Depreciation	200	156	27.8%	116	72.3%	200	0.0%
<b>EBIT- ex forex</b>	<b>352</b>	<b>268</b>	<b>31.3%</b>	<b>250</b>	<b>41.1%</b>	<b>374</b>	<b>-5.9%</b>
Other income	5	63	-92.7%	-21	-122.3%	-32	-114.4%
<b>PBT - before minority</b>	<b>357</b>	<b>331</b>	<b>7.8%</b>	<b>229</b>	<b>55.8%</b>	<b>342</b>	<b>4.3%</b>
Minority Interest- Pipal Research	-1	-3	-73.0%	-1	-35.8%	-5	-84.6%
<b>PBT - after minority</b>	<b>358</b>	<b>334</b>	<b>7.2%</b>	<b>230</b>	<b>55.3%</b>	<b>347</b>	<b>3.0%</b>
Prov for Tax	8	32	-73.6%	13	-35.9%	69	-87.9%
<b>PAT</b>	<b>349</b>	<b>302</b>	<b>15.7%</b>	<b>217</b>	<b>60.8%</b>	<b>278</b>	<b>25.8%</b>
<b>Margins</b>							
EBITDA	20.1%	19.8%	33bps	22.7%	-260bps	21.4%	-128bps
EBIT	12.8%	12.5%	33bps	15.5%	-268bps	13.9%	-111bps
PAT	12.7%	14.1%	-134bps	13.5%	-77bps	10.3%	237bps
Dep % to sales	7.3%	7.3%	bps	7.2%	7bps	7.4%	-17bps
Tax rate	2.3%	9.5%	-718bps	5.7%	-334bps	20.0%	-1766bps

Source: Company

**Table 2: Estimates revision table**

Earnings revision table	New		Old		Change	
	<b>FY08</b>	<b>FY09</b>	<b>FY08</b>	<b>FY09</b>	<b>FY08</b>	<b>FY09</b>
Revenue (Rs mn)	12,820	17,240	12,758	16,956	0.5%	1.7%
EBIT (Rs mn)	1,702	2,508	1,627	2,344	4.7%	7.0%
EBIT margin	13.3%	14.5%	12.7%	13.8%	53bps	73bps
PAT (Rs mn)	1,521	2,195	1,456	2,051	4.5%	7.0%
EPS diluted (Rs)	3.30	4.76	3.16	4.45	4.4%	6.9%

Source: Merrill Lynch Estimates

**Table 3: Profit and loss statement**

Rs million	2005	2006	2007	2008E	2009E
<b>Revenue</b>	<b>3,219.0</b>	<b>5,487.5</b>	<b>8,297.6</b>	<b>12,819.7</b>	<b>17,240.0</b>
<b>EXPENDITURE</b>					
Operating cost	1,101.6	1,856.3	2,518.2	3,663.7	4,653.0
Personnel cost	1,600.6	2,832.5	4,135.6	6,575.4	9,030.9
<b>EBITDA</b>	<b>516.8</b>	<b>798.7</b>	<b>1,643.8</b>	<b>2,580.6</b>	<b>3,556.1</b>
Depreciation / amortisation	329.9	451.5	641.5	878.3	1,048.3
<b>EBIT</b>	<b>186.9</b>	<b>347.2</b>	<b>1,002.3</b>	<b>1,702.3</b>	<b>2,507.9</b>
Other income	(13.5)	(77.5)	24.0	96.4	149.6
<b>Profit/(loss) before tax</b>	<b>173.4</b>	<b>269.7</b>	<b>1,026.3</b>	<b>1,798.8</b>	<b>2,657.5</b>
Provision for tax	(2.9)	27.0	60.1	268.5	449.6
<b>Profit/ (loss) after tax before minority interest</b>	<b>176.3</b>	<b>242.7</b>	<b>966.1</b>	<b>1,530.3</b>	<b>2,207.9</b>
Minority interest	(4.79)	(4.07)	(6.3)	9.0	12.9
<b>Profit/(loss) after tax and minority interest</b>	<b>181.1</b>	<b>246.8</b>	<b>972.4</b>	<b>1,521.3</b>	<b>2,195.0</b>

Source: Merrill Lynch Research, Company

**Table 4: Balance sheet**

31st Mar- Rs 'mn	FY05	FY06	FY07	FY08E	FY09E
<b>SOURCES OF FUNDS</b>					
<b>Shareholders' funds</b>					
Share capital (equity share cap+ preference share cap)	3,983.4	3,994.7	4,250.8	4,250.8	4,250.8
Share application	-	2.0	-	-	-
Reserve and surplus	77.7	327.5	6,414.7	7,631.8	9,387.8
<b>Total Shareholders' funds</b>	<b>4,061</b>	<b>4,324</b>	<b>10,666</b>	<b>11,883</b>	<b>13,639</b>
<b>Minority interest</b>	<b>55.8</b>	<b>49.2</b>	<b>42.9</b>	<b>51.9</b>	<b>64.8</b>
<b>Loan funds</b>					
Secured loans	647.9	731.1	712.0	159.4	49.4
Unsecured loans	394.7	569.1	1,263.9	201.4	201.4
Deferred tax liability, net	0	0	6.8	6.8	6.8
<b>Total</b>	<b>5,160</b>	<b>5,674</b>	<b>12,691</b>	<b>12,302</b>	<b>13,961</b>
<b>APPLICATION OF FUNDS</b>					
<b>Goodwill on consolidation</b>	<b>3,611.9</b>	<b>4,072.6</b>	<b>5,419.2</b>	<b>5,419.2</b>	<b>5,419.2</b>
<b>Fixed assets</b>					
Gross block	2,027.5	2,575.8	3,891.3	4,891.3	5,591.3
Less: Accumulated depreciation	1,077.5	1,486.5	2,171.1	3,049.4	4,097.7
<b>Net block</b>	<b>950</b>	<b>1,089</b>	<b>1,720</b>	<b>1,842</b>	<b>1,494</b>
Add: Capital work in progress	54.5	64.3	82.0	82.0	82.0
<b>Total Fixed Assets</b>	<b>1,005</b>	<b>1,154</b>	<b>1,802</b>	<b>1,924</b>	<b>1,576</b>
<b>Deferred tax asset</b>	<b>4.3</b>	<b>3.9</b>	<b>5.8</b>	<b>5.8</b>	<b>5.8</b>
<b>Investments</b>			<b>1,152.5</b>	<b>1,152.5</b>	<b>1,152.5</b>
<b>Current assets, loans and advances</b>					
Sundry debtors	618.9	1,006.9	1,364.0	2,249.7	3,062.2
Cash and bank balances	269.4	170.3	3,010.0	1,741.8	3,406.0
Loans and advances	318.1	457.3	1,306.2	1,306.2	1,306.2
<b>Total Current Assets</b>	<b>1,206</b>	<b>1,635</b>	<b>5,680</b>	<b>5,298</b>	<b>7,774</b>
Less: Current liabilities and provisions					
Current liabilities	637.0	1,149.8	1,255.6	1,405.6	1,843.1
Provisions	30.6	41.2	113.2	91.4	123.5
<b>Total Current liabilities and provisions</b>	<b>668</b>	<b>1,191</b>	<b>1,369</b>	<b>1,497</b>	<b>1,967</b>
<b>Net current assets</b>	<b>539</b>	<b>444</b>	<b>4,311</b>	<b>3,801</b>	<b>5,808</b>
<b>Total</b>	<b>5,160</b>	<b>5,674</b>	<b>12,691</b>	<b>12,302</b>	<b>13,961</b>

Source: Merrill Lynch Research, Company

28 April 2007

**Table 5: Cash flow statement**

Rs million	FY05	FY06	FY07	FY08E	FY09E
<b>Cash Flow from Operating Activities</b>					
Net Income	181	247	972	1,521	2,195
Depreciation and amortisation	330	451	642	878	1,048
Gain on sale of property and equipment	(12)	1			
Deferred Income Taxes	(3)	0	(7)		
Changes in Operating assets and liabilities, net of effect of acquisition					
Accounts Receivables	(141)	(388)	(953)	(886)	(813)
Other current assets	(53)	(135)	328	-	
Deposits					
Interest	25	80	64	166	167
Accounts Payable					
Deferred Revenues					
Other Current Liabilities	65	120	(49)	128	470
Others	16	(6)	(83)		
<b>Total operating cash flow</b>	<b>408</b>	<b>371</b>	<b>914</b>	<b>1,809</b>	<b>3,068</b>
<b>Cash Flow from Investing Activities</b>					
Acquisition, net of Cash acquired	(1,957)	(73)	(1,837)	-	-
Capex	(614)	(594)	(1,154)	(1,000)	(700)
Proceeds from sale of property and equipment	26	6			
Goodwill Impact					
Others	13	7	(1,055)	-	-
<b>Net Cash from Investing Activities</b>	<b>(2,532)</b>	<b>(653)</b>	<b>(4,046)</b>	<b>(1,000)</b>	<b>(700)</b>
<b>Free Cash Flow</b>	<b>(206)</b>	<b>(223)</b>	<b>(240)</b>	<b>809</b>	<b>2,368</b>
<b>Cash Flow from Financing Activities</b>					
Ordinary shares issued and subscribed	1,625	16	5,400	-	-
Minority	-	-	-	9	13
Principal payments under capital leases					
Proceeds from notes payable, net of financing costs			923		
Repayment of debt	716	254	(230)	(1,615)	(110)
Interest	(29)	(87)	(121)	(166)	(167)
Dividend Paid	-	-	-	(304)	(439)
<b>Net Cash from Financing Activities</b>	<b>2,312</b>	<b>183</b>	<b>5,972</b>	<b>(2,077)</b>	<b>(703)</b>
<b>Net change in cash and cash equivalents</b>	<b>188</b>	<b>(99)</b>	<b>2,840</b>	<b>(1,268)</b>	<b>1,664</b>
Cash and eq at the beginning of the year	81	269	170	3,010	1,742
<b>Cash and eq at the end of the year</b>	<b>269</b>	<b>170</b>	<b>3,010</b>	<b>1,742</b>	<b>3,406</b>

Source: Merrill Lynch Research, Company

**Table 6: Key ratios**

	FY05	FY06	FY07	FY08E	FY09E
<b>Margins</b>					
Gross Margin	34.6%	33.0%	37.8%	35.1%	34.6%
EBITDA	17.0%	14.6%	19.8%	20.1%	20.6%
EBIT	6.1%	6.3%	12.1%	13.3%	14.5%
PAT	5.6%	4.5%	11.7%	11.9%	12.7%
Tax rate	-1.6%	9.9%	5.8%	15.0%	17.0%
<b>Per Share Data</b>					
Basic EPS (INR)	1.0	1.2	3.7	3.6	5.2
Diluted EPS (INR)	0.7	0.8	2.5	3.3	4.8
CEPS (INR)	5.9	9.1	11.8	10.6	7.6
Dividend Payout %	0.0%	0.0%	0.0%	20.0%	20.0%
Dividend Per Share (INR)	-	-	-	0.7	1.0
Book-value (INR)	15.4	13.9	27.4	25.8	29.6
PE- basic	86.2	66.9	22.4	22.9	15.9
PE- diluted	119.5	103.2	32.9	24.9	17.3
<b>Growth Ratios</b>					
Revenue	79.6%	70.5%	51.2%	54.5%	34.5%
EBITDA	168.3%	45.6%	105.8%	57.0%	37.8%
EBIT	469.2%	77.1%	188.7%	69.9%	47.3%
PAT	2879.5%	36.2%	294.2%	56.4%	44.3%
Basic EPS (INR)	683.9%	28.8%	199.2%	-2.5%	44.3%
Diluted EPS (INR)	684.6%	15.8%	214.0%	32.0%	44.3%
<b>Return Ratios</b>					
RONW	5.6%	5.9%	13.0%	13.5%	17.2%
RONW ex cash	6.0%	6.1%	16.5%	15.5%	20.2%
ROCE	5.9%	7.1%	11.9%	14.4%	19.5%
ROCE ex cash	6.2%	7.3%	15.0%	16.7%	23.6%
<b>Other Key Metrics</b>					
Assets Turnover	0.6	1.0	0.6	1.0	1.2
Payables days	34	25	35	35	35
DSO	69	66	65	65	65
Current assets as a % of sales	37.5%	29.8%	68.5%	41.3%	45.1%
Cash and cash equivalents	269	170	3,010	1,742	3,406
Accounts receivable, net	619	1,007	1,364	2,250	3,062
Free cash flow	(206)	(223)	(240)	809	2,368
Cash realization ratio	2.3	1.5	0.9	1.2	1.4

Source: Merrill Lynch Research, Company

## Price Objective Basis & Risk

Our PO is at 22x FY09E PE at a PEG of 0.9 and current FY08 PE of 25x. It takes into account strong 50% PAT CAGR and 38% EPS CAGR (post IPO dilution), and higher stickiness of BPO revenues. It implies FY08E EV/sales of 2.5x, at 20% discount to WNS, which we believe is fair given lower margins and returns.

Risks: Growing competition from integrated players like Accenture and Infosys, rising employee attrition and risk of Rupee appreciation.

## Analyst Certification

I, Mitali Ghosh, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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***iQmethod*<sup>SM</sup> Measures Definitions**

<b>Business Performance</b>	<b>Numerator</b>	<b>Denominator</b>
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
<b>Quality of Earnings</b>		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
<b>Valuation Toolkit</b>		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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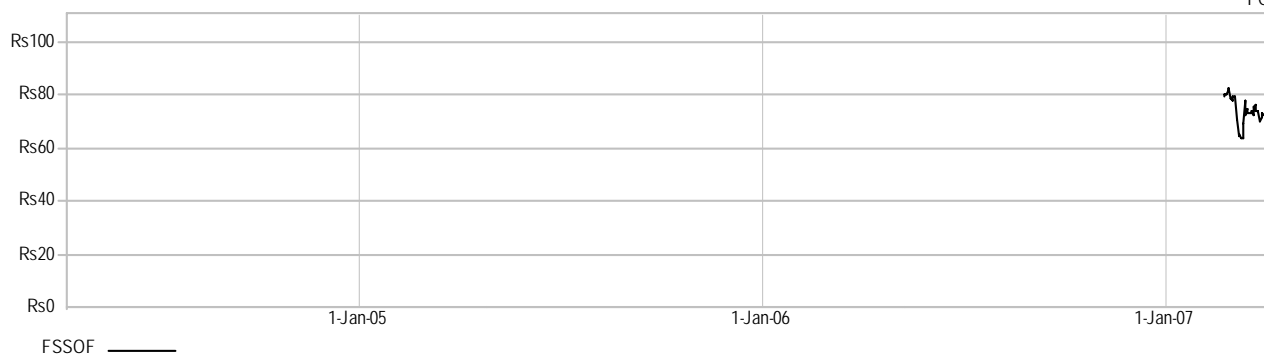
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## Important Disclosures

### FSSOF Price Chart

11-Apr:B  
Ghosh  
PO:Rs95


B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of March 31, 2007 or such later date as indicated.

### Investment Rating Distribution: Technology Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	114	41.76%	Buy	21	20.39%
Neutral	146	53.48%	Neutral	31	22.79%
Sell	13	4.76%	Sell	1	9.09%

### Investment Rating Distribution: Global Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1562	45.16%	Buy	415	30.09%
Neutral	1615	46.69%	Neutral	446	30.65%
Sell	282	8.15%	Sell	49	19.76%

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