



Infosys Technologies

STOCK INFO. BSE SENSEX: 12,353	BLOOMBERG INFO IN	11 October 2006	
S&P CNX: 3,559	REUTERS CODE INFY.BO	<i>Previous Recommendation: Buy</i>	Buy
Equity Shares (m)	555.8		Rs1,981
52-Week Range	2,024/1,201		
1,6,12 Rel. Perf. (%)	7/20/3		
M.Cap. (Rs b)	1,101.2		
M.Cap. (US\$ b)	23.7		

* 1:1 bonus in FY07, accordingly ratios are adjusted, PAT figures are adjusted PAT

- **Strong volume growth, margin improvement drive up profits:** Infosys' revenues for 2QFY07 increased 14.5% QoQ to Rs34.5b against our expectation of Rs33.6b. EBITDA margins have gone up to 32.1% from 29.5% in 1QFY07 resulting into PAT (before extra-ordinary items) growth of 17% QoQ at Rs9.3b (expectation of Rs8.7b).
- **Increased hiring, client surveys indicate strong volume growth ahead:** The company has revised its gross employee addition target for FY07 to 28K from 25K earlier, indicative of strong volume growth in 2HFY07 as well as in FY08. A survey of its clients, which indicates flat to 4% increase in IT spending for CY07, with improved offshore IT spending, indicates sustained demand scenario in FY08.
- **Pricing environment remains benign:** Consolidated price realization increased 1.8% QoQ. Billing rates have been inching up over the past few quarters due to improvement in service mix and increased proportion of new business. The company has also mentioned that it has renegotiated 1-2% higher rates with some existing clients.
- **High revenue visibility, guidance revision result in earnings upgrade; Buy:** FY07 revenue guidance up to Rs138.53-138.99b, implying YoY growth of 45.5-46% (earlier growth guidance was 40.2-40.7%). FY07 EPS guidance is up by 5% to Rs66 (YoY growth of 47%) from the earlier guidance of Rs62.3-62.9 (YoY growth of 38-40%). With consistent positive surprises in price realization and robust volume growth, we have revised our EPS estimates for FY07 and FY08 by 5% and 8.6% to Rs68.7 and Rs86.6, respectively. The stock trades at 28.8x FY07E and 22.9x FY08E EPS. We reiterate **Buy** with a price target of Rs2,165 (upside of 9%).

QUARTERLY PERFORMANCE									(Rs Million)	
Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Revenues	20,716	22,940	25,320	26,240	30,150	34,510	37,120	39,348	95,216	141,127
Q-o-Q Change (%)	4.2	10.7	10.4	3.6	14.9	14.5	7.6	6.0	33.5	48.2
Direct Expenses	11,044	12,120	13,270	14,220	16,660	18,330	19,738	20,762	50,654	75,489
Sales, General & Admin. Expenses	3,033	3,480	3,440	3,690	4,600	5,090	5,345	5,233	13,643	20,268
Operating Profit	6,638	7,340	8,610	8,330	8,890	11,090	12,037	13,353	30,918	45,369
Margins (%)	32.0	32.0	34.0	31.7	29.5	32.1	32.4	33.9	32.5	32.1
Other Income	286	440	-50	720	1,250	660	862	884	1,396	3,656
Depreciation	801	960	1,170	1,440	1,060	1,220	1,578	1,771	4,371	5,628
PBT bef. Extra-ordinary	6,123	6,820	7,390	7,610	9,080	10,530	11,321	12,466	27,943	43,397
Provision for Tax	802	690	830	810	1,060	1,230	1,330	1,471	3,132	5,091
Rate (%)	13.1	10.1	11.2	10.6	11.7	11.7	11.8	11.8	11.2	11.7
PAT bef. Minority	5,331	6,130	6,560	6,800	8,020	9,300	9,991	10,995	24,811	38,306
Minority Interest	-2	-60	-70	-70	-80	-10	-14	-15	-210	-119
Extra-ordinary items	0	-10	0	0	60	0			-18	60
PAT aft. Minority and ext-ord	5,330	6,060	6,490	6,730	8,000	9,290	9,977	10,980	24,583	38,247
Q-o-Q Change (%)	3.8	13.7	7.1	3.7	18.9	16.1	7.4	10.0	33.1	55.6

E: MOST Estimates

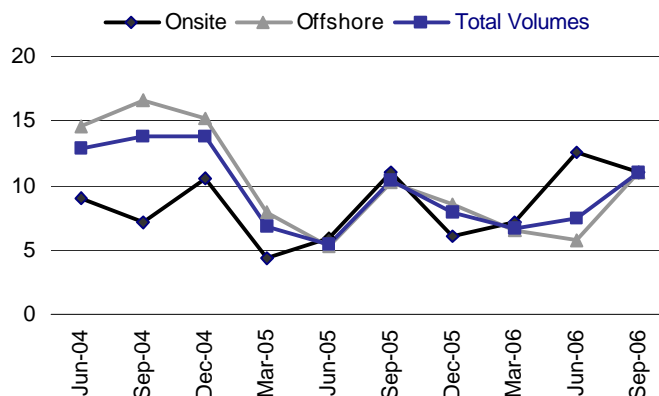
Strong volume growth, margin improvement drive up profits

Infosys' revenues for 2QFY07 increased 14.5% QoQ to Rs34.5b against our expectation of Rs33.6b, backed by volume growth of 11% QoQ and 1.8% QoQ increase in consolidated price realization. EBIDTA margins have gone up to 32.1% (against our estimate of 31.4%) from 29.5% in 1QFY07. Lower visa costs, rupee depreciation and reduction in SG&A expenses led to a margin expansion of 110bp, 90bp and 60bp, respectively. Net profit (before extraordinary items) was up 17% QoQ to Rs9.3b against our expectation of Rs8.7b due to stronger than expected revenue growth and margin improvement. This is despite the lower than expected other income of Rs660m (expectation of Rs788m).

Indication of strong volume growth ahead

Volume growth for the quarter remained strong at 11% QoQ, as against our expectation of 10% QoQ. Onsite volumes grew 11% QoQ and offshore volumes kept pace, registering growth of 10.9% QoQ. Total volume growth is trending upwards and the management remains confident of retaining the pace of growth over the coming quarters. Currently, Infosys is confident of the current demand scenario sustaining in FY08 following a survey of its clients, which indicates flat to 4% increase in IT spending in FY08, with improved offshore IT spending. Infosys has also mentioned that its addressable pie has increased by 3-4% due to expansion of service portfolio, which we believe could result into higher wallet share with its existing as well as new clients.

CHART: VOLUME GROWTH REMAINS ROBUST (% GROWTH)



Source: Company/Motilal Oswal Securities

We expect volume growth to remain robust in 2HFY07 despite the fact that 3QFY07 would have 3% less working days. Our belief is strengthened by the company's lateral employee additions and trainee numbers over 1HFY07. Infosys had around 4,351 trainees at the end of 1QFY07, which has increased to 6,284 trainees at the end of 2QFY07. A considerable proportion of these trainees would become billable in 2HFY07. In addition, lateral addition as a percentage of total gross/net addition continues to remain high, which would also add to the billable resource pool. With guidance for US\$ revenues for FY07 increasing 2.7% to >US\$3b, the company has revised its gross employee addition target for FY07 to 28K from 25K earlier. We believe that this is indicative of high volume growth in 2HFY07 as well as in FY08.

STRONG EMPLOYEE ADDITIONS INDICATIVE OF HIGH VOLUME GROWTH(NOS)

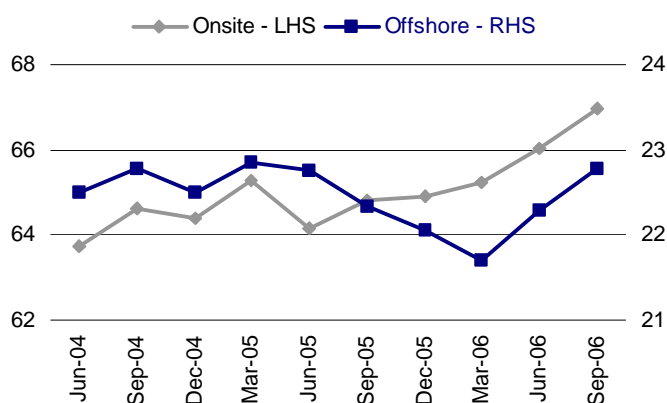
	JUN-05	SEP-05	DEC-05	MAR-06	JUN-06	SEP-06
Billable	34,611	38,541	39,494	42,604	48,438	53,873
Banking Product	1,328	1,351	1,677	1,863	1,817	1,809
Trainees	1,207	3,549	5,313	5,028	4,351	6,284
Total Software	37,146	43,441	46,484	49,495	54,606	61,966
Lateral Addition	1,129	1,166	927	1,620	2,140	2,560
% of Total Net Addition	36.9	18.2	28.7	49.2	37.6	33.1
% of Total Gross Addition	24.9	14.5	18.1	31.3	26.4	23.7

Source: Company/Motilal Oswal Securities

Pricing environment remains benign

Consolidated price realization increased 1.8% QoQ. While onsite realizations improved 1.4% QoQ, offshore realizations improved 2.2% QoQ. Billing rates have been inching up over the past few quarters due to improvement in service mix and increased proportion of new business (which has 3-4% higher billing rates). The company has also mentioned that it has renegotiated 1-2% higher rates with some existing clients. The management believes that the pricing environment is not aggressive at present and expects rates to remain stable, with new contracts/renegotiations happening at slightly higher rates.

CONSOLIDATED BILLING RATES CONTINUE TO SEE UP TICK



Source: Company/Motilal Oswal Securities

Wallet share gains in top clients to continue, with expansion in service offerings

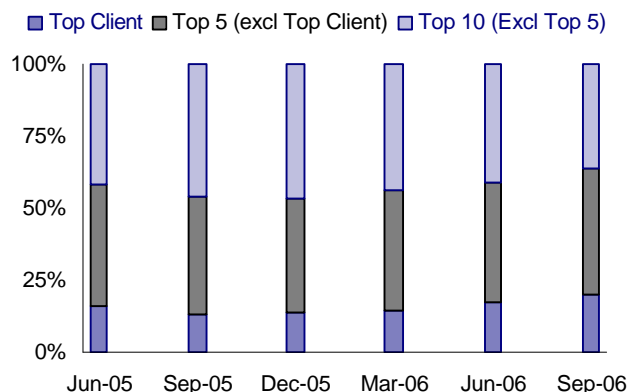
Infosys' top client grew 30.2% QoQ to 6.6% of total revenue (up from 5.8% in 1QFY07). The bottom half of the top-10 clients grew slower at 11.6%, with contribution to revenue declining to 11.9% from 12.2% in 1QFY07 and 12.6% in FY06. Increase in contribution of top-5 clients is due to wallet share gains on account of effective cross-selling of new services, which has resulted in a growth of 3-4% in Infosys' addressable pie.

TOP CLIENT GROWTH (%)

	SEP-05	DEC-05	MAR-06	JUN-06	SEP-06
Top Client	-6	13	8	41.8	30.2
Top 5	3.2	9.1	9.5	20.5	23.3
Top 10	6.6	7.8	7.4	17.5	18.8
Top 10 (Excl. Top 5)	11.6	6.1	4.5	13.0	11.6

Source: Company/Motilal Oswal Securities

CONTRIBUTION OF TOP-5 CLIENTS RISING



Source: Company/Motilal Oswal Securities

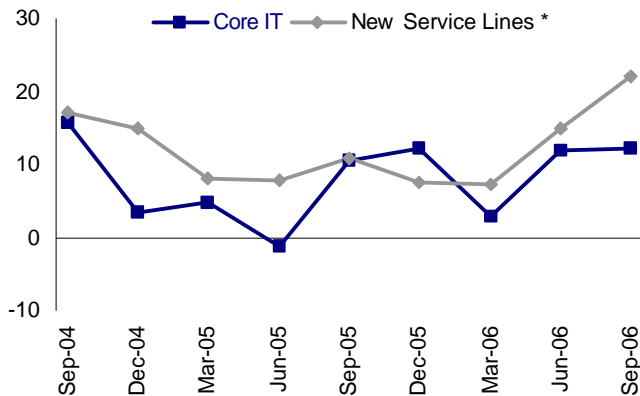
Client transition to higher revenue brackets remained strong, with the number of clients giving >US\$70m revenue doubling from 3 to 6. Infosys has been investing heavily in its sales and marketing team and focusing on cross-functional/horizontal sales, which we believe is beginning to yield results. We expect the resultant wallet share gains to culminate in greater number of clients transitioning to higher revenue brackets. With increase in the number of Fortune 500 clients (45 clients were added during the quarter, including 10 Fortune 500 clients), we expect Infosys to be able to effectively grab greater wallet share from new clients, as well.

MORE CLIENTS TRANSITIONING TO HIGHER REVENUE BRACKETS (%)

TRANSITION RATE	SEP-05	DEC-05	MAR-06	JUN-06	SEP-06
> US\$1m	8.4	10.3	7.4	8.5	8.5
> US\$5m	10.3	10.9	7.1	12.8	11.3
> US\$10m	18.3	20.9	14.8	18.8	20.1
> US\$20m	10.3	11.3	7.4	12.1	11.3
> US\$30m	11.0	9.7	7.9	8.1	7.5
> US\$40m	14.7	22.5	10.6	10.8	10.0
> US\$50m	7.3	8.0	23.7	13.4	12.5
> US\$60m	8.8	0.0	6.3	-4.0	0.0
> US\$70m	5.1	0.0	14.8	0.0	13.2
> US\$80m	5.9	6.4	0.0	0.0	0.0
> US\$90m	0.0	0.0	0.0	6.1	5.6

Source: Company/Motilal Oswal Securities

NEW SERVICE LINES CONTINUE STRONG GROWTH, TO HELP ACCOUNT PENETRATION



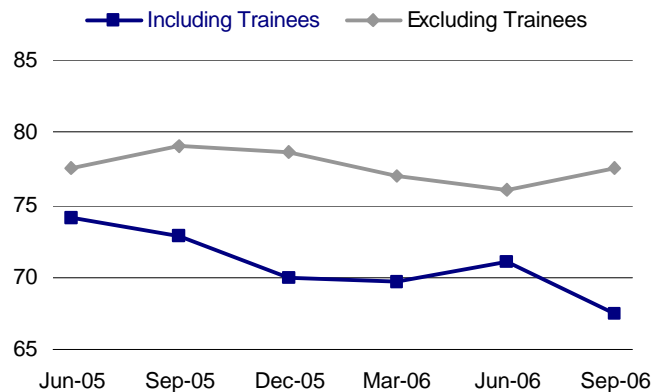
* Includes BPO, Testing, Consulting and Package Implementation
 Source: Company/Motilal Oswal Securities

Newer service lines such as package implementation, testing, BPO and consulting grew at a robust 17.9%, 25.5%, 22.6% and 37.4%, respectively. These service lines have continued to outpace growth from core IT services such as ADM, re-engineering, etc. over the past several quarters. With increase in newer service offerings, we expect improvement in price realizations as well as client penetration.

Higher utilization, offshoring to help stem margin fall due to wage inflation

EBITDA margins have expanded to 32.1% (our estimate of 31.4%) from 29.5% in 1QFY07. Lower visa cost, reduction in SG&A expenses and rupee depreciation led to a margin expansion of 110bp, 60bp and 90bp, respectively. The management expects FY07 margins at 31.5-32%. In 1HFY07, Infosys registered EBITDA margin of 30.9%, which implies improvement in margins in 2HFY07 despite expected rupee appreciation in 2HFY07 (average realized rupee-dollar rate for 1HFY07 is Rs46/dollar, guided FY07 rate is Rs45.6/dollar, implied 2HFY07 rate is Rs45.2/dollar against current rate of Rs45.8/dollar).

UTILIZATION RATES (INCLUDING TRAINEES) OFFER MARGIN CUSHION



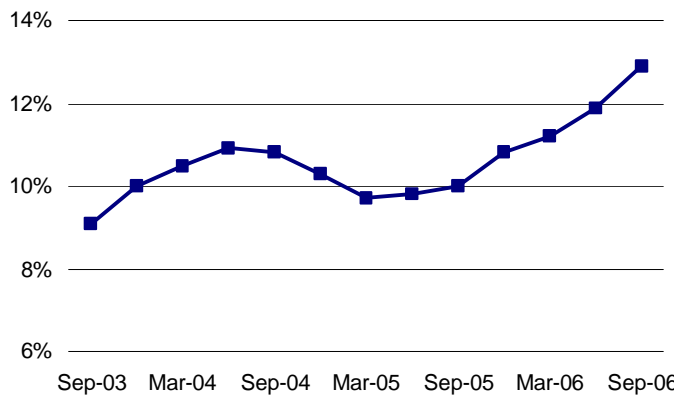
Source: Company/Motilal Oswal Securities

We expect higher utilization and offshore contribution to result in margin expansion during 2HFY07. Utilization rate including trainees declined 67.5% in 2QFY07 from 71.1% in 1QFY07. Infosys had around 4,351 trainees at the end of 1QFY07 and 6,284 trainees at the end of 2QFY07. A considerable proportion of these would become billable in 2HFY07. Therefore, we expect significant improvement in utilization rates, going forward.

Rising attrition - cause for concern

Gross employee addition was high at 10,795, with net addition of 7,741. Attrition rose to 12.9% from 11.9% in 1QFY07 due to forced attrition and greater attrition in the >1 year experienced employee bracket, which has contributed to around 2.9% attrition. The company has increased salaries for employees completing 1 year during the quarter to contain attrition, the impact of which is restricted to around US\$2.6m per quarter. However, rising attrition rates continue to remain a cause for concern - the management has stated that supply side issues would be the primary challenge in the near term. The unexpected wage hikes in 2QFY07 also indicate that the management is more open to dynamic wage adjustment, which could also put pressure on margins, going forward.

ATTRITION CONTINUES TO INCH UPWARDS



Source: Company/Motilal Oswal Securities

High revenue visibility, guidance revision results in earnings upgrade

3QFY07 sales growth guidance at 4.4-5% and EPS guidance of Rs16.84 (QoQ growth of just 0.7%) is muted (in rupee terms) considering likely appreciation in the rupee. However the management has indicated that most of the growth in 3QFY07 will be volume driven, indicating QoQ volume growth of 6-6.6% in 3QFY07.

HIGH REVENUE/PROFIT VISIBILITY

	FY07			
	1Q	2Q	3Q GUI- DANCE	4Q RESI- DUAL GR.
Revenues	30,150	34,510	36,250	38,080
Q-o-Q Change (%)	14.9	14.5	5.0	5.0
Net Profit	8,000	9,290	9,359	10,032
Q-o-Q Change (%)	18.9	16.1	0.7	7.2

Source: Company/Motilal Oswal Securities

Infosys has once again revised its revenue guidance for FY07 up to Rs138.53-138.99b, implying YoY growth of 45.5-46% (earlier growth guidance was 40.2-40.7%). Dollar sales guidance has also been increased by 2.7% to >US\$3b, which indicates management confidence in sustaining growth in 2HFY07. FY07 EPS guidance has increased by 5% to Rs66 (YoY growth of 47%) from the earlier guidance of Rs62.3-62.9 (YoY growth of 38-40%) and our earlier EPS estimate of Rs65.6.

We remain positive on Infosys, given the high revenue visibility and presence of margin cushions such as utilization rates, offshore mix. With consistent positive surprises in price realization and robust volume growth, we have revised our EPS estimates for FY07, FY08 by 5% and 8.6% to Rs68.7 and Rs86.6, respectively. The stock trades at 28.8x FY07E and 22.9x FY08E EPS. We reiterate **Buy** with a price target of Rs2,165 (upside of 9%).

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 66,000 people. It provides IT / ITES services to more than 475 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. Narayana Murthy stepped down from executive Chairman effective 20 August 2006. He will continue to serve as non-executive Chairman and Chief Mentor.
- ✎ Mr. Nandan Nilekani has taken over as CEO and MD, effective 20 August 2006.

Valuation and view

- ✎ CAGR of 40.3% and 39.9% in revenues and profit respectively over FY06-FY08E.
- ✎ Valuations at of 22.9x FY08E still offer room for upside.
- ✎ We maintain **Buy** for a price target of Rs2,165, upside of 9%.

Sector view

- ✎ Various CIO surveys indicate increasing share of offshore spending in IT budgets. However, any slowdown in the US economy could impact discretionary spending.
- ✎ 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	28.8	25.4	27.4
	FY08E	22.9	21.0	22.4
P/BV (x)	FY07E	10.8	11.3	7.6
	FY08E	7.9	8.0	6.1
EV/Sales (x)	FY07E	7.5	5.4	4.9
	FY08E	5.5	4.2	3.8
EV/EBITDA (x)	FY07E	23.3	20.2	20.8
	FY08E	17.4	16.1	16.1

SHAREHOLDING PATTERN (%)

	JUN.06	MAR.06	JUN.05
Promoter	19.4	19.5	19.8
Domestic Inst	7.2	6.5	4.8
Foreign	53.9	56.4	58.1
Others	19.5	17.6	17.3

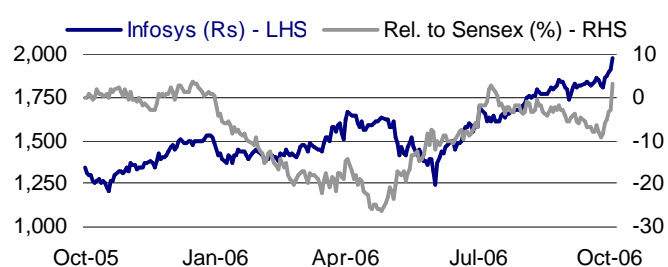
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	68.7	64.1	7.2
FY08	86.6	80.2	8.0

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
1,981	2,165	9.3	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Sales	71,296	95,216	141,127	187,420	236,204
Change (%)	49.8	33.5	48.2	32.8	26.0
Software Develop. Exp.	37,647	50,654	75,489	102,983	132,944
Selling and Mktg. Exp.	4,610	6,005	8,834	11,245	13,700
Administration Exp.	5,690	7,639	11,435	14,299	17,653
EBITDA	23,350	30,918	45,369	58,893	71,907
% of Net Sales	32.8	32.5	32.1	31.4	30.4
Depreciation	2,869	4,371	5,628	7,965	10,393
Other Income	1,239	1,396	3,656	3,897	5,105
PBT	21,720	27,943	43,397	54,824	66,619
Tax	3,256	3,132	5,091	6,631	8,749
Rate (%)	15.0	11.2	11.7	12.1	13.1
Minority Interest		210	119	74	100
Adjusted PAT	18,464	24,601	38,187	48,119	57,769
Extraordinary Income	-452	18	-60	0	0
Reported PAT	18,916	24,583	38,247	48,119	57,769
Change (%)	51.0	30.0	55.6	25.8	20.1

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Share Capital	1,353	1,380	2,779	2,779	2,779
Share Premium	8,999	15,430	18,290	18,290	18,290
Reserves	41,900	52,850	80,938	118,644	163,900
Net Worth	52,251	69,660	102,007	139,713	184,969
Preference Capital	935	0	0	0	0
Minority Interest	0	680	129	203	303
Loans	0	0	0	0	0
Capital Employed	53,188	70,340	102,136	139,916	185,273
Gross Block	22,873	29,830	50,940	68,940	88,940
Less : Depreciation	10,308	13,280	18,908	26,874	37,267
Net Block	12,565	16,550	32,032	42,066	51,673
CWIP	3,177	5,710	5,000	5,000	5,000
Investments	12,108	7,550	25,000	40,000	60,000
Curr. Assets	39,664	63,990	64,623	88,774	119,606
Debtors	13,220	16,080	26,452	30,031	41,153
Cash & Bank Balance	15,756	34,290	15,940	33,627	43,823
Loans & Advances	10,244	12,970	21,465	24,266	33,368
Other Current Assets	444	650	766	851	1,262
Current Liab. & Prov	14,326	23,460	24,518	35,924	51,006
Creditors	5,354	7,320	11,239	13,408	17,655
Other liabilities	1,207	2,020	2,314	3,409	3,777
Provisions	7,766	14,120	10,965	19,107	29,574
Net Current Assets	25,338	40,530	40,104	52,851	68,600
Application of Funds	53,187	70,340	102,136	139,917	185,274

E: M0St Estimates

RATIOS *					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Basic (Rs)					
EPS	34.5	44.6	68.7	86.6	103.9
Cash EPS	40.7	52.5	78.9	100.9	122.6
Book Value	97.6	126.4	183.5	251.4	332.8
DPS	6.4	22.5	13.1	16.4	19.7
Payout %(Incl.Div.Taxes)	20.6	57.4	21.7	21.7	21.7
Valuation (x)					
P/E		44.4	28.8	22.9	19.1
Cash P/E		37.7	25.1	19.6	16.2
EV/EBITDA		34.1	23.3	17.4	13.8
EV/Sales		11.1	7.5	5.5	4.2
Price/Book Value		15.7	10.8	7.9	6.0
Dividend Yield (%)		1.1	0.7	0.8	1.0
Profitability Ratios (%)					
RoE	44.6	40.3	44.6	39.8	35.6
RoCE	50.2	45.2	50.3	45.3	41.0
Turnover Ratios					
Debtors (Days)	68	62	68	58	64
Fixed Asset Turnover (x)	3.1	3.2	2.8	2.7	2.7
Leverage Ratio (x)					
Debt/Equity Ratio(x)	0.0	0.0	0.0	0.0	0.0

* 1:1 bonus in FY07, accordingly ratios are adjusted

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
CF from Operations	23,450	30,190	40,395	52,346	63,568
Cash for Working Capital	-9,755	-9,856	-10,004	3,798	-7,010
Net Operating CF	13,696	20,334	30,391	56,144	56,558
Net Purchase of FA	-8,298	-10,890	-20,400	-18,000	-20,000
Net Purchase of Invest.	-1,059	6,660	-13,794	-11,103	-14,895
Net Cash from Invest.	-9,357	-4,230	-34,194	-29,103	-34,895
Proceeds from Equity & other	4,408	6,460	1,695	0	0
Proceeds from LTB/STB	0	0	0	0	0
Dividend Payments	-10,206	-4,030	-16,242	-9,353	-11,468
Cash Flow from Fin.	-5,798	2,430	-14,548	-9,353	-11,468
Free Cash Flow	21,187	605	23,241	5,725	43,184
Net Cash Flow	-1,459	18,534	-18,351	17,688	10,195
Opening Cash Balance	17,215	15,756	34,290	15,939	33,627
Add: Net Cash	-1,459	18,534	-18,351	17,688	10,195
Closing Cash Balance	15,756	34,290	15,939	33,627	43,822

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