



BHEL

| | |
|--------------------|--------------|
| STOCK INFO. | BLOOMBERG |
| BSE Sensex: 14,212 | BHEL IN |
| | REUTERS CODE |
| S&P CNX: 4,124 | BHEL.BO |

29 January 2007

Buy

Rs2,506

Previous Recommendation: Buy

| | |
|-----------------------|-------------|
| Equity Shares (m) | 244.8 |
| 52-Week Range | 2,668/1,531 |
| 1,6,12 Rel. Perf. (%) | 4/1/3 |
| M.Cap. (Rs b) | 613.3 |
| M.Cap. (US\$ b) | 13.9 |

| 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 |
| 03/06A | 136,873 | 16,769 | 68.5 | 73.7 | 36.6 | 8.4 | 25.2 | 39.6 | 4.3 | 22.3 |
| 03/07E | 177,217 | 23,649 | 96.6 | 41.0 | 25.9 | 6.6 | 28.6 | 43.8 | 3.2 | 15.6 |
| 03/08E | 212,028 | 28,965 | 118.3 | 22.5 | 21.2 | 5.3 | 27.8 | 41.7 | 2.7 | 12.5 |

Robust 3QFY07 performance: During 3QFY07, BHEL reported net revenues of Rs43.4b (up 31% YoY), EBITDA of Rs9.3b (up 54% YoY) and net profit of Rs6.7b (up 58% YoY). The reported numbers were higher than our expectations: revenue Rs44.4b, EBITDA Rs7.8b and net profit Rs5.6b.

Positive surprises from EBITDA margin improvement: The key surprise during 3QFY07 has been the improvement in EBITDA margins to 21.4% (up 330bp YoY). This compares with 13.7% during 2QFY07 (up 780bp QoQ). The increase is largely due to lower staff cost (as % of revenues) at 11.8% during 3QFY07, v/s 13.6% YoY and lower SGA expenses at 10.1% v/s 11.3% during the same period. Raw material cost (as % of revenues) stood at 56.7% during 3QFY07, v/s 56.9% during 3QFY06.

Order backlog at Rs467b (up 42% YoY): BHEL's order backlog as at December 2006 stood at Rs467b (up 42% YoY), of which power division accounted for Rs356b. The current order backlog however does not include orders worth Rs35b (1,000MW) from Damodar Valley Corporation received in January 2007. Thus, the order backlog of Rs502b (including DVC's recent order win) translates into a book to bill ratio of 2.7x FY07E revenues of Rs188.6b.

Valuation and view: Given the order book of Rs502b (incl recent DVC order win), BHEL has strong revenue growth visibility going forward. We expect revenue CAGR of 21% and net profit CAGR of 27% over FY06-09E. The stock trades at P/E of 25.9x FY07E, 21.2x FY08E and 17.7x FY09E. Maintain **Buy**.

QUARTERLY PERFORMANCE

| Y/E MARCH | FY06 | | | | FY07 | | | | (Rs Million) | |
|------------------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|----------------|----------------|
| | 1Q | 2Q | 3Q | 4Q | 1Q | 2Q | 3Q | 4QE | FY06 | FY07E |
| Sales | 19,365 | 25,103 | 33,267 | 55,157 | 26,564 | 33,412 | 43,397 | 70,328 | 132,892 | 173,701 |
| Change (%) | 65.4 | 45.2 | 45.5 | 23.5 | 37.2 | 33.1 | 30.5 | 27.5 | 40.0 | 30.7 |
| EBITDA | 1,715 | 3,689 | 6,029 | 11,949 | 3,182 | 4,563 | 9,292 | 15,477 | 23,382 | 32,514 |
| Change (%) | 332.0 | 66.0 | 70.8 | 37.0 | 85.5 | 23.7 | 54.1 | 29.5 | 65.4 | 39.1 |
| As a % Sales | 8.9 | 14.7 | 18.1 | 21.7 | 12.0 | 13.7 | 21.4 | 22.0 | 17.6 | 18.7 |
| Depreciation | 576 | 624 | 620 | 640 | 639 | 667 | 662 | 657 | 2,459 | 2,624 |
| Interest | 123 | 133 | 136 | 195 | 131 | 136 | 120 | 159 | 587 | 545 |
| Other Income | 931 | 1,057 | 1,187 | 2,133 | 1,201 | 1,699 | 1,855 | 2,284 | 5,308 | 7,038 |
| PBT | 1,947 | 3,989 | 6,460 | 13,247 | 3,613 | 5,460 | 10,365 | 16,945 | 25,644 | 36,383 |
| Tax | 668 | 1,388 | 2,229 | 4,567 | 1,246 | 1,860 | 3,688 | 5,940 | 8,852 | 12,734 |
| Effective Tax Rate (%) | 34.3 | 34.8 | 34.5 | 34.5 | 34.5 | 34.1 | 35.6 | 35.1 | 34.5 | 35.0 |
| Reported PAT | 1,279 | 2,602 | 4,232 | 8,680 | 2,367 | 3,600 | 6,677 | 11,005 | 16,792 | 23,649 |
| Change (%) | 444.3 | 64.4 | 78.3 | 48.5 | 85.1 | 38.4 | 57.8 | 26.8 | 76.1 | 40.8 |
| Adj. PAT | 1,279 | 2,602 | 4,232 | 8,680 | 2,367 | 3,600 | 6,677 | 11,005 | 16,792 | 23,649 |
| Change (%) | 266.8 | 64.4 | 78.3 | 48.5 | 85.1 | 38.4 | 57.8 | 26.8 | 74.1 | 40.8 |

E: MOST Estimates; Other Income includes Operational Other Income

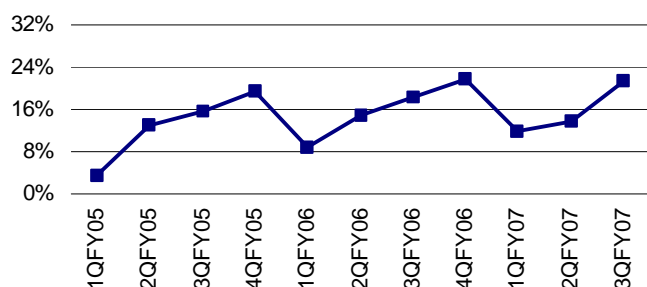
Robust 3QFY07 performance

During 3QFY07, BHEL reported net revenues of Rs43.4b (up 31% YoY), EBITDA of Rs9.3b (up 54% YoY) and net profit of Rs6.7b (up 58% YoY). The reported numbers were higher than our expectations: revenue Rs44.4b, EBITDA Rs7.8b and net profit Rs5.6b.

Positive Surprises from EBITDA margin improvement

During 3QFY07, BHEL's EBITDA increased 54% YoY to Rs9.3b driven by 330bp YoY improvement in EBITDA margins to 21.4%. This compares with 13.7% during 2QFY07 (up 780bp QoQ). The increase is largely due to lower staff cost (as % of revenues) at 11.8% during 3QFY07, v/s 13.6% YoY and lower SGA expenses at 10.1% v/s 11.3% during the same period. Raw material cost (as % of revenues) stood at 56.7% during 3QFY07, v/s 56.9% during 3QFY06.

TREND IN EBITDA MARGIN (%)



Source: Company/Motilal Oswal Securities

SEGMENT WISE ANALYSIS (RS M)

| | 1QFY06 | 2QFY06 | 3QFY06 | 4QFY06 | 1QFY07 | 2QFY07 | 3QFY07 |
|----------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| Revenue | | | | | | | |
| Power | 16,087 | 21,080 | 27,518 | 44,254 | 21,828 | 27,141 | 35,387 |
| Growth (%) | 76.5 | 62.8 | 55.0 | 22.9 | 35.7 | 28.8 | 28.6 |
| % of Total | 73.6 | 73.2 | 74.2 | 71.5 | 73.9 | 72.3 | 73.5 |
| Industrial | 5,774 | 7,713 | 9,568 | 17,624 | 7,708 | 10,399 | 12,741 |
| Growth (%) | 35.3 | 14.3 | 15.5 | 18.0 | 33.5 | 34.8 | 33.2 |
| % of Total | 26.4 | 26.8 | 25.8 | 28.5 | 26.1 | 27.7 | 26.5 |
| Intersegment | 718 | 916 | 940 | 1,172 | 661 | 886 | 1,029 |
| Total | 21,143 | 27,877 | 36,146 | 60,706 | 28,875 | 36,654 | 47,099 |
| EBIT | | | | | | | |
| Power | 2,163 | 4,221 | 6,325 | 10,984 | 4,089 | 5,789 | 8,457 |
| Margin (%) | 13.4 | 20.0 | 23.0 | 24.8 | 18.7 | 21.3 | 23.9 |
| % of Total | 83.1 | 78.6 | 82.3 | 75.8 | 91.9 | 82.0 | 84.4 |
| Industrial | 440 | 1,147 | 1,360 | 3,516 | 362 | 1,268 | 1,565 |
| Margin % | 7.6 | 14.9 | 14.2 | 20.0 | 4.7 | 12.2 | 12.3 |
| % of Total | 16.9 | 21.4 | 17.7 | 24.2 | 8.1 | 18.0 | 15.6 |

Source: Company/Motilal Oswal Securities

Industrial division witnesses margin pressures from higher commodity prices

Power division reported strong 3QFY07 performance, with revenues at Rs35.3b, up 29% YoY and EBIT of Rs8.5b, up 34% YoY. EBIT margins improved to 23.9% in 3QFY07, from 23% in 3QFY06. Industrial division witnessed margin pressure during 3QFY07, and reported revenues at Rs12.7b, up 33% YoY and EBIT of Rs1.6b, up 15% YoY. EBIT margins of the industrial division declined to 12.3% in 3QFY07, down from 14.2% in 3QFY06. Industrial division now accounts for 27% of revenues and 16% of EBIT.

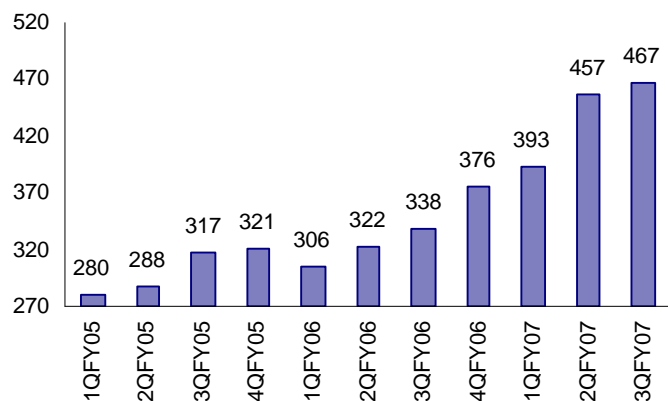
The key reason for EBIT margin decline in the industrial division has been the higher commodity prices, particularly copper and CRGO. Industrial business entails fixed price contracts, and thus sharp increase in commodity prices have eroded margins. Going forward, we expect EBITDA margins to improve, given the moderation in terms of increase in copper prices.

During 9MFY07, the revenue for the power division grew by 30% YoY to Rs84.4b while revenues for industrial division grew by 34% YoY to Rs30.8b. During the same period, EBIT margins for the power division stood at 21.7% (up 209bp YoY) and for industrial division at 10.4% (down 243bp YoY).

Order backlog at Rs467b (up 38% YoY)

BHEL's order backlog as at December 2006 stood at Rs467b (up 38% YoY), of which power division accounted for Rs356b. The current order backlog however does not include orders worth Rs35b (1,000MW) from Damodar Valley Corporation received in January 2007. Thus, the order backlog of Rs502b (including DVC's recent order win) translates into a book to bill ratio of 2.7x FY07E revenues of Rs188.6b. The average execution cycle for the power division is 24-36 months while for the industrial division, it is 12-18 months.

TREND IN ORDER BACKLOG (RS B)



Source: Company/Motilal Oswal Securities

Ramp in capacity to meet higher demand

BHEL is investing Rs16b to expand its capacity from 6,000MW to 10,000MW. Of the 10,000MW expanded capacity, coal / nuclear will be 6,500MW, Hydro 2,500MW and gas based 1,000MW. The increased capacity is expected to be fully operational by December 2007. The management indicated that they have already spent a sizable amount (60%+) of the above capex, and the balance amount would be invested by mid FY08. The company has also started taking various initiatives to develop vendor base and sub-contractor network with a view to outsourcing simple fabrication work and utilizing its own facilities for high value added jobs.

In next phase of expansion, the company is already working on plans to increase the capacity to 15,000 MW by FY09. The capex envisaged in this phase is expected at Rs32b (of which Rs25b is for expansion and Rs7b for modernization).

Valuation and view

Given the order book of Rs502b, BHEL has strong revenue growth visibility going forward. We expect revenue CAGR of 21% and net profit CAGR of 27% over FY06-09E. The stock trades at P/E of 25.9x FY07E, 21.2x FY08E and 17.7x FY09E. Maintain **Buy**.

BHEL: an investment profile

Company description

BHEL is India's dominant producer of power and industrial machinery and a leading EPC company, established in the late 1950s as the government's wholly-owned subsidiary. Post divestment, the government currently has an equity stake of 67.7%. The company has 14 manufacturing divisions, 8 service centers, 4 power sector regional centers besides project sites spread across all over India and abroad. It has an annual installed capacity of 6,000MW. It has formed a tie-up with Alstom and an alliance with Siemens for the manufacture of super-critical 800MW boilers and turbines respectively.

Key investment arguments

- ✍ Order backlog at end 3QFY07 stands at Rs507b, a book to bill ratio of 2.7x FY07E.
- ✍ Increasing investments in country's power sector especially to build 68,000MW generating capacity in the XIth five year plan will ensure higher order intake.
- ✍ Technology transfer agreement with Alstom and Siemens for super critical boilers has enabled the company to plug the technology gaps from the product portfolio.

Key investment risks

- ✍ The key challenge is to meet execution deadlines and improve cost efficiencies.
- ✍ Intensified competition from Chinese, Korean, etc suppliers.

Recent developments

- ✍ The company announced an interim dividend of Rs12.5/sh and bonus in the ratio of 1:1.
- ✍ Announced order intake of 1,000MW from Damodar Valley Corporation for 1,000MW.

Valuation and view

- ✍ Given the order book of Rs507b, BHEL has strong revenue growth visibility going forward. We expect revenue CAGR of 21% and net profit CAGR of 27% over FY06-09E.
- ✍ The stock trades at P/E of 25.9x FY07E, 21.2x FY08E and 17.7x FY09E. Maintain **Buy**.

Sector view

- ✍ We expect ramp up in power sector investments, across segments – generation, transmission and distribution.
- ✍ We maintain our positive view on the sector.

COMPARATIVE VALUATIONS

| | | BHEL | L&T | CROMPTON |
|---------------|-------|------|------|----------|
| P/E (x) | FY07E | 25.9 | 25.4 | 28.1 |
| | FY08E | 21.2 | 20.6 | 22.2 |
| P/BV (x) | FY07E | 6.6 | 7.4 | 12.1 |
| | FY08E | 5.3 | 6.4 | 9.4 |
| EV/Sales (x) | FY07E | 3.2 | 2.4 | 2.3 |
| | FY08E | 2.7 | 2.0 | 1.9 |
| EV/EBITDA (x) | FY07E | 15.6 | 24.4 | 23.0 |
| | FY08E | 12.5 | 19.7 | 17.7 |

SHAREHOLDING PATTERN (%)

| | DEC.06 | SEP.06 | DEC.05 |
|-----------------------|--------|--------|--------|
| Promoters | 67.7 | 67.7 | 67.7 |
| Domestic Institutions | 7.5 | 7.4 | 7.6 |
| FII's/FDIs | 21.7 | 22.0 | 22.1 |
| Others | 3.1 | 2.9 | 2.6 |

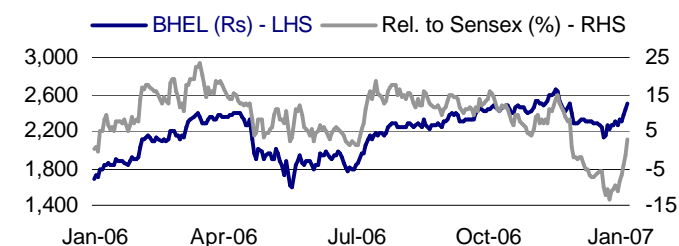
EPS: MOST FORECAST VS CONSENSUS (RS)

| | MOST FORECAST | CONSENSUS FORECAST | VARIATION (%) |
|------|---------------|--------------------|---------------|
| FY07 | 96.6 | 96.4 | 0.2 |
| FY08 | 118.3 | 117.9 | 0.4 |

TARGET PRICE AND RECOMMENDATION

| CURRENT PRICE (RS) | TARGET PRICE (RS) | UPSIDE (%) | RECO. |
|--------------------|-------------------|------------|-------|
| 2,506 | 2,823 | 12.7 | Buy |

STOCK PERFORMANCE (1 YEAR)



| INCOME STATEMENT | | | | | | RATIOS | | | | | |
|----------------------------------|---------------------|----------------|----------------|----------------|----------------|------------------------------|---------------------|---------------|---------------|---------------|---------------|
| (Rs Million) | | | | | | | | | | | |
| Y/E MARCH | 2005 | 2006 | 2007E | 2008E | 2009E | Y/E MARCH | 2005 | 2006 | 2007E | 2008E | 2009E |
| Total Income | 99,663 | 136,873 | 177,217 | 212,028 | 243,311 | Basic (Rs) | | | | | |
| Change | 18.8 | 40.4 | 29.9 | 19.5 | 14.7 | EPS | 39.4 | 68.5 | 96.6 | 118.3 | 141.2 |
| Staff Cost | 16,504 | 18,785 | 21,603 | 27,004 | 29,704 | Change (%) | 17.5 | 73.7 | 410 | 22.5 | 19.3 |
| Mfg. Expenses | 47,784 | 69,424 | 89,765 | 108,930 | 125,341 | Cash EPS | 48.4 | 78.6 | 107.3 | 130.3 | 154.2 |
| Selling Expenses | 18,393 | 22,806 | 29,819 | 32,128 | 36,241 | Book Value | 246.2 | 298.3 | 377.3 | 473.7 | 588.4 |
| EBITDA | 16,982 | 25,858 | 36,031 | 43,965 | 52,025 | DPS | 8.0 | 14.5 | 16.0 | 20.0 | 24.0 |
| Change | 25.6 | 52.3 | 39.3 | 22.0 | 18.3 | Payout (incl. Div. Tax.) | 23.0 | 23.3 | 18.2 | 18.6 | 18.7 |
| % of Net Sales | 17.0 | 18.9 | 20.3 | 20.7 | 21.4 | Valuation (x) | | | | | |
| Depreciation | 2,189 | 2,459 | 2,624 | 2,933 | 3,200 | P/E | | 36.6 | 25.9 | 21.2 | 17.7 |
| Interest | 814 | 587 | 545 | 725 | 725 | Cash P/E | | 31.9 | 23.3 | 19.2 | 16.2 |
| Other Income | 2,037 | 2,797 | 3,522 | 4,254 | 5,060 | EV/EBITDA | | 22.3 | 15.6 | 12.5 | 10.2 |
| Extra-ordinary Items (net) | -200 | 35 | 0 | 0 | 0 | EV/Sales | | 4.3 | 3.2 | 2.7 | 2.2 |
| PBT | 15,817 | 25,644 | 36,383 | 44,561 | 53,160 | Price/Book Value | | 8.4 | 6.6 | 5.3 | 4.3 |
| Tax | 6,282 | 8,852 | 12,734 | 15,596 | 18,606 | Dividend Yield (%) | | 0.6 | 0.6 | 0.8 | 1.0 |
| Rate (%) | 39.7 | 34.5 | 35.0 | 35.0 | 35.0 | Return Ratio | | | | | |
| Reported PAT | 9,534 | 16,792 | 23,649 | 28,965 | 34,554 | RoE | 17.1 | 25.2 | 28.6 | 27.8 | 26.6 |
| Adjusted PAT | 9,655 | 16,769 | 23,649 | 28,965 | 34,554 | RoCE | 29.6 | 39.6 | 43.8 | 41.7 | 40.1 |
| Change | 17.5 | 73.7 | 410 | 22.5 | 19.3 | Turnover Ratios | | | | | |
| BALANCE SHEET | (Rs Million) | | | | | Debtors (Days) | 248 | 228 | 226 | 224 | 222 |
| Y/E MARCH | 2005 | 2006 | 2007E | 2008E | 2009E | Inventory (Days) | 121 | 119 | 110 | 110 | 110 |
| Share Capital | 2,448 | 2,448 | 2,448 | 2,448 | 2,448 | Creditors. (Days) | 87 | 89 | 81 | 78 | 76 |
| Reserves | 57,821 | 70,566 | 89,907 | 113,487 | 141,579 | Asset Turnover (x) | 9.1 | 13.6 | 13.3 | 13.3 | 14.6 |
| Net Worth | 60,269 | 73,014 | 92,355 | 115,935 | 144,027 | Leverage Ratio | | | | | |
| Loans | 5,370 | 5,582 | 5,150 | 5,150 | 5,150 | Debt/Equity (x) | 0.1 | 0.1 | 0.1 | 0.0 | 0.0 |
| Differed Tax Liability | -5,183 | -6,737 | -600 | -600 | -600 | CASH FLOW STATEMENT | (Rs Million) | | | | |
| Capital Employed | 60,456 | 71,859 | 96,905 | 120,485 | 148,577 | Y/E MARCH | 2005 | 2006 | 2007E | 2008E | 2009E |
| Gross Fixed Assets | 36,289 | 38,221 | 43,529 | 48,919 | 52,834 | PBT before EO Items | 16,017 | 25,608 | 36,383 | 44,561 | 53,160 |
| Less: Depreciation | 25,847 | 28,398 | 30,452 | 33,285 | 36,485 | Add: Depreciation | 2,189 | 2,459 | 2,624 | 2,933 | 3,200 |
| Net Fixed Assets | 10,442 | 9,823 | 13,077 | 15,633 | 16,348 | Interest | 814 | 587 | 545 | 725 | 725 |
| Capital WIP | 953 | 1,846 | 1,592 | 900 | 900 | Less: Direct taxes paid | 6,282 | 8,852 | 12,734 | 15,596 | 18,606 |
| Investments | 90 | 83 | 150 | 150 | 150 | (Inc)/Dec in WC | -2,910 | -1,576 | -6,844 | -11,395 | -7,975 |
| Curr. Assets | 133,430 | 158,063 | 215,759 | 262,941 | 313,923 | CF from operations | 9,827 | 18,228 | 19,975 | 21,227 | 30,504 |
| Inventory | 29,161 | 37,444 | 46,327 | 57,451 | 67,142 | EO Income | -200 | 35 | 0 | 0 | 0 |
| Debtors | 59,721 | 71,681 | 95,267 | 116,960 | 135,324 | CF from Operations in | 9,627 | 18,263 | 19,975 | 21,227 | 30,504 |
| Cash & Bank Balance | 31,779 | 41,340 | 56,474 | 66,794 | 86,197 | (Inc)/dec in FA | -1,557 | -2,732 | -5,625 | -4,798 | -3,915 |
| Loans & Advances | 12,297 | 11,999 | 16,846 | 20,891 | 24,415 | CF from investments | -1,357 | -2,726 | -5,692 | -4,798 | -3,915 |
| Other Current Assets | 472 | 845 | 845 | 845 | 845 | (Inc)/Dec in Networkth | -19 | -1,697 | 6,137 | 0 | 0 |
| Current Liab. & Prov. | 84,459 | 97,955 | 133,673 | 159,140 | 182,745 | (Inc)/Dec in Debt | -30 | 213 | -432 | 0 | 0 |
| Creditors | 20,997 | 28,041 | 33,948 | 40,566 | 46,518 | Less: Interest Paid | 814 | 587 | 545 | 725 | 725 |
| Other Liabilities | 50,208 | 54,792 | 79,212 | 94,654 | 108,542 | Dividend Paid | 2,225 | 3,904 | 4,308 | 5,385 | 6,462 |
| Provisions | 13,254 | 15,123 | 20,513 | 23,921 | 27,684 | CF from Fin. Activity | -3,088 | -5,976 | 852 | -6,110 | -7,187 |
| Net Current Assets | 48,971 | 60,108 | 82,086 | 103,801 | 131,178 | Inc/Dec of Cash | 5,182 | 9,561 | 15,135 | 10,320 | 19,402 |
| Misc. Expenses | 0 | 0 | 0 | 0 | 0 | Add: Beginning Balance | 26,596 | 31,779 | 41,340 | 56,474 | 66,794 |
| Application of Funds | 60,456 | 71,859 | 96,905 | 120,485 | 148,577 | Closing Balance | 31,779 | 41,340 | 56,474 | 66,794 | 86,197 |

E: MOST Estimates



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Disclosure of Interest Statement

| | BHEL |
|---|-------------|
| 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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