



Cathay FHC (2882 TT)

Financial

HOLD

Initiation

ML Research Team**Equity Analyst**

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Recommendation

Hold

Date: August 16, 2005

Share Price (NT\$): 61.30

Price Target (NT\$): 64.70

Percent Change: 4.35%

52-wk range (NT\$): 53.80-64.35

TWSE: 6245.13

Company Data

Capital Size (NT\$): 84.74bn

Market Cap (NT\$): 525.38bn

Market Cap (US\$): 16.41bn

Outstanding Shrs: 8,474mn

Free Floating Shrs: 7,920mn

PER ('06E): 19.79x

PBR ('06E): 2.75x

Foreign Ownership: 29.22%

Major Shareholder: Group -related investment company 34.83%

Performance

Absolute (%) 1-m 3-m 6-m

(1.13) 10.23 0.51

Relative to TAIX (0.28) 4.44 (1.63)

Key Changes

Recommendation Current Prev.

Price Target (NT\$) 64.70 NA

Revenue ('06E NT\$bn) 28.6 NA

Gross Margin (%) 100% NA

Oper. Margin (%) 99.80% NA

EPS ('06E NT\$) 3.27 NA

Price Catalysts (+,-)

(+) Improving stock trading gains

(-) Over pay for state bank acquisition

Related Research

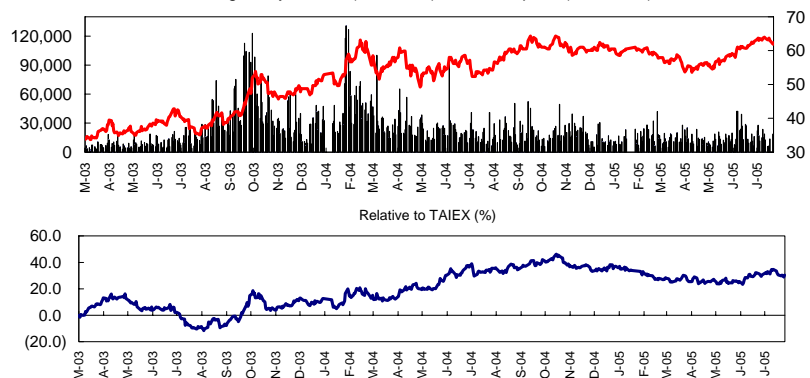
E. Sun FHC (2804 TT) July 1, 2005

FEIB (2845 TT) July. 29, 2005

Company Initiation Report

- We are initiating coverage on Cathay Financial Holding Company, Cathay FHC, with a hold rating of NT\$64.70 target price. We think the current price has factored in the improving 2H05 earnings expectation and the next share price rally will require a more definite progress on the FHC's state bank buyout plan.
- **Laggard 1H05 earning result** The FHC just announced NT\$10.6bn earnings for 1H05, down by 41.11% YoY. Company management explained the decline was because of a lower contribution from the life insurance subsidiary, Cathay Life, who reported a net earnings of NT\$4.2bn, a drop of 57.14% YoY, driven by poor investment yield.
- **Improving 2H05 Life Insurance Earning** We project improving earnings for 2H05, not only for the NT \$5.0bn cash dividend but also a healthier equity market lately, as the company has fueled in additional funding (NT\$11.6bn in 2Q05) to TAIEX and the index has gained 5.74% since 1Q05.
- **Risk factors** Like most of leading FHCs in Taiwan, Cathay FHC's current challenge is how to win a state bank to keep up its dominating position. We believe Cathay's financial might should allow it to win any state bank on the auction table. However, it is reported that the FHC will take a cautious approach to the issue and might pass over the bidding chance on Taiwan Business Bank (2834 TT, NT\$12.40, Buy), which might raise the risk to over pay for the next available privatized state bank.
- **Hold** As much as we think the FHC deserves a higher valuation for its leading position and generous cash dividend payout history, we recommend investors to wait for more definite progress on the state bank acquisition, and to hold the share with a target price of NT\$64.70 (4.32% upside), which equals to 2.75x PB multiple based on our 2006 BV forecast of NT\$23.52 per share.

Average daily volume ('000, LHS) and share price (NT\$, RHS)



Investment Keynotes

Cathay FHC Recent Development

Cathay FHC, Taiwan's number-one listed financial company, is a dual-business focus FHC on life insurance and banking. The FHC just announced NT\$10.6bn earnings for 1H05, down by 41.11% YoY.

The company explained the decline was because of a lower contribution from the life insurance subsidiary,

Cathay Life, who reported a net earning of NT\$4.2bn, a drop of 57.14% YoY driven by poor investment yield. On the other hand, banking operating earnings increased with a mediocre level of 2.27% due to rising funding cost, despite of 11.39% loan book growth. Nevertheless, net banking earning also dropped by 18.51% to NT\$6.6bn due to a higher basis in 1H04 constituted by two buildings sales. Lastly the property & casualty insurance subsidiary, Cathay Century, also delivered a 38.76%-cut in earnings at NT\$0.29bn.

Figure 1: Cathay FHC controlling assets & subsidiaries contribution (NT\$bn)

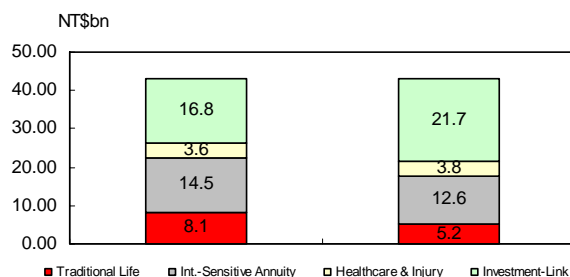
	Total Assets Controlled		Total Revenue Generated				Earnings Contribution			
	2005/06		2004		2005/06		2004		2005/06	
Cathay Life Insurance	1,706.8	62.0%	354.9	85.2%	160.9	85.0%	15.6	51.8%	4.2	37.9%
Cathay United Bank	1,032.8	37.5%	52.9	12.7%	23.6	12.5%	13.9	46.1%	6.6	59.5%
Cathay Century Insurance	11.9	0.4%	9.0	2.1%	4.8	2.5%	0.6	2.1%	0.3	2.6%
Total	2,751.5	100.0%	416.8	100.0%	189.3	100.0%	30.1	100.0%	11.1	100.0%

Source: Company data; MasterLink Securities

Cathay Life

Established in 1962, Cathay Life is Taiwan's oldest and biggest domestic life insurer. The insurer has reclaimed the leadership of 1st-year (or new contract) premium revenue in this June, after losing the long-sustained title to Nanshan Life, AIG's insurance arm in Taiwan, during the first five months this year. Nonetheless, Cathay's 1st-year premium revenue in 1H05 increased merely by 0.70% compared with same period last year, as a mixed result of 35.80% and 13.10% drops on traditional life and interest-sensitive annuity, and 29.17% rise on investment-link products. On the other hand, total premium revenue inched up by 3.77% on a yearly basis to NT\$145.8bn for the same period.

Figure 2: Cathay Life 1st-Year Premium Revenue Mix



Source: Company data, MasterLink Securities

While the persistency ratios, which indicate the likelihood to generate future profitability from the existing policy contracts, are falling, we think it is an industry-wide phenomenon driven by the fierce competition during 1Q05 and believe the situation is under the control, as most of life insurer competitors have stopped selling "Singlepremium Immediate Annuity" which triggered gross policy transferring during 1Q05. Moreover, Cathay Life's persistency is still at manageable level, compared with the past five years data.

Figure 3: Cathay Life Persistency Trend

	2002	2003	2004	1H04	1H05
13 Mo. Persistency %	90.05	91.00	90.10	92.00	90.03
25 Mo. Persistency %	84.12	83.98	85.60	85.40	85.10

Source: Company MasterLink Securities

Although Cathay Life's leading position seemed challenged recently for its hesitance to push riskier but well-receiving products, such as Singlepremium Immediate Annuity or participant policies, its most precious assets, the powerful sales force, remained intact. The company still possesses the biggest sales team of 84K people that promptly won back the championship of the new contract sales as soon as the hot products were ready. We believe the sales team will become the insurer's most powerful tool for the upcoming sales activities for pension products that just heat up in Taiwan

after the open of New Pension Act in this July.

On the regulatory side, the authority might soon adopt a flexible liability reserve requirement that allow life insurers to apply higher discount rates for long-maturity products, instead of using a fixed rate for all policies currently. We believe the policy change will lower down long-maturity policies' pricing and thus encourage more subscription on such a product and hence to relieve insurers' profitability pressures.

We project improving investment earnings for 2H05, not only for the NT \$5.0bn cash dividend but also a bullish equity market lately, as the company has injected additional funding (NT\$11.6bn in 2Q05) to TAIEX and the index has gained 5.74% since 1Q05. Going forward, we also expect an healthier trend for the insurer's investment yield as the government is apt to loose up the overseas investment limit to 50% of total investment assets from current 35% to enhance the investment efficiency.

Figure 4: Cathy Life Investment Fund Mix

	1Q05		2Q05		Change	
	NT\$bn	%	NT\$bn	%	NT\$bn	%
Cash, & Equivalent	239.8	14.78	245.2	14.84	5.4	2.25
Domestic Stock	126.8	7.81	138.4	8.38	11.6	9.15
Overseas Stock	35	2.16	34.2	2.07	-0.8	-2.29
Domesic Bond	117.3	7.23	118.5	7.17	1.2	1.02
Overseas Bond	516.7	31.84	526.4	31.86	9.7	1.88
Secured Loan	449.7	27.71	447.7	27.10	-2	-0.44
Real Estates	114.2	7.04	114.2	6.91	0	0.00
Others	23.1	1.42	27.6	1.67	4.5	19.48
Total	1,622.6	100.00	1,652.2	100.00	29.6	1.82

Source: Company; MasterLink Securities

REITs Issuance

Cathy Life's first REITs issuance is under the authority's reviews and is scheduled to be ready for sale at the beginning of 4Q05. We estimate this NT\$14.0bn offering will fuel in a capital gain of NT\$6.3bn after retaining 25% issuance. Company further indicated that securitisation will be used more often to dispose its property holdings in the future.

Figure 5: REITs Issuance Estimate (NT\$m)

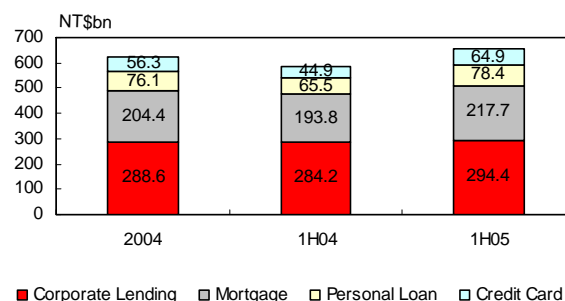
Issuing Amount	14,000
Underlying Property BV	5,700
Retention %	25.00
Capital Gains	6,225

Source: MasterLink Securities

Cathay United Bank

Cathy United Bank is a consumer-banking centric business with total consumer borrowing taking 55.08% of the loan book in 1H05. Compared with one year ago in 1H04 mortgage, personal loan, and credit card lending continued to thrive by 12.33%, 19.69% and 44.54%, individually, and thus constituted 11.39% loan book growth to NT\$655.4bn in 1H05. In the meantime, total operating income grew by 18.61% to NT\$23.64bn, driven by 20.65%-up interest income and 6.37%-up fee income. However, net operating earning only increased with a mediocre level of 2.27% to NT\$9.0bn due to rising funding cost.

Figure 6: Cathay United Loan Book

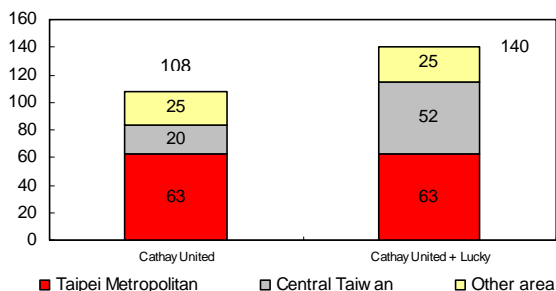


Source: Company data; MasterLink Securities

As the company indicated, we believe the bank's current business highlight is to leverage its existing customer base to enhance cross sell the group's life insurance products. Moreover, with the backing of 84K-people sales force from the life insurance subsidiary, we are optimistic about the group's future cross selling, and anticipate it to achieve highest cross-selling activities among all the FHCs in Taiwan, especially on the group products.

Cathay FHC just spent NT\$4.1bn in cash to acquire 81.35% Lucky Bank, a small bank with NT\$90.0bn in assets (8.89% of Cathay United's) and all its 32 branches in Taiwan's central area. The acquisition has promptly strengthened Cathay United Bank's branch number from 20 to 52 in mid Taiwan, covering Taichung, Hsinchu, and Taoyuan. In our forecast, we assume Cathay FHC will complete the remaining 18.65% acquisition by 2005end in cash. We believe the transaction makes no impact to the FHC's ambition to acquire state bank for maintaining its banking channel at top ranking, but has eased the pressure to bid up immediately to win the next state bank on the auction table.

Figure 7: Cathay United Branch Network Allocation



Source: Company data; MasterLink Securities

Risk Factors

We currently do not worry Cathay FHC's earning capability for 2H05, as we believe the investment income from Cathay Life should improve grossly and make up for the laggard earnings in the first half. Like most of the leading FHCs in Taiwan, with the exception of Taishin FHC (2887 TT, NT\$22.70, HOLD), Cathay FHC's current challenge is how to win a state bank to keep up its dominating position. We believe Cathay's financial might should allow it to win any available state bank. However, it is reported that the FHC will take a cautious approach to the issue and might pass over the bidding chance on Taiwan Business Bank (2834 TT, NT\$12.40, BUY), which might raise the risk to over pay for the next available privatized state bank or FHC.

Valuation and Recommendation

Hold with a target price of NT\$64.70

The share is currently trading at 2.65x one-year-forward PB multiple, which is at the mid range of its valuation of 2.35x~2.90x within the past 12 months. As much as we think the FHC deserves a higher valuation for its leading position and generous dividend payout history, we recommend investor to wait for more definite progress on the state bank acquisition and to hold the share with a target price of NT\$64.70 (4.32% upside), which equals to 2.75x PB multiple based on our 2006 BV forecast of NT\$23.52 per share.

Figure 8: Cathay FHC PB Band



Source: Company data; MasterLink Securities

Cathay Life P&L					NT \$mn
Year to December	2002	2003	2004	2005E	2006E
Net Premium Revenue	255,580	236,090	256,739	277,278	299,460
Benefit to Policyholders	122,855	134,132	161,668	171,912	164,703
Net Provision & Reserve	271,624	267,813	282,313	291,142	299,460
Recoveries	115,136	128,756	142,283	124,775	95,827
Total Insurance Underwriting	(23,764)	(37,099)	(44,959)	(61,001)	(68,876)
Interest Income (Net)	43,915	47,245	51,837	63,321	65,914
Real Estate Investment (Net)	4,484	4,513	4,718	10,312	7,439
Other Investments (Net)	4,757	11,030	19,457	16,146	21,385
Other Operating Revenue (Net)	(3,109)	2,296	(4,388)	(1,500)	600
Total Operating Revenue	26,284	27,985	26,665	27,278	26,462
SG&A	10,904	10,244	10,753	12,185	12,908
Operating Earning (Net)	15,380	17,741	15,913	15,092	13,555
Non Operating (Net)	679	2,029	(650)	-	-
Pretax Earnings	16,059	19,770	15,262	15,092	13,555
Tax Expense	3,213	1,940	(356)	1,509	1,355
Net Earnings	12,846	17,831	15,619	13,583	12,199
Cathay Life Investment Fund Mix					NT \$mn
Year to December	2002	2003	2004	2005E	2006E
Investment Return:					
Interest Assets Yield	5.9%	5.5%	5.0%	5.3%	5.3%
Real Estate Investment Yield	4.9%	4.8%	4.8%	10.6%	7.0%
Trading, Dividend, Unrealized Yield	1.9%	3.2%	6.1%	4.5%	5.5%
Total Investment Yield	4.7%	4.8%	5.3%	5.5%	5.4%
Interest Income (Net)	43,915	47,245	51,837	63,321	65,914
Real Estate Investment (Net)	4,484	4,513	4,718	10,312	7,439
Trading, Dividend, Unrealized, (Net)	4,757	11,030	19,457	12,623	17,446
Total Investment Income	53,157	62,788	76,012	86,256	90,800
Investment Assets:					
Total Cash & Equivalent	182,013	156,946	296,584	261,522	235,368
Marketable Securities	235,354	348,405	231,319	299,116	298,474
Secured Loans	488,113	478,633	450,828	457,664	486,086
Policy Loans	-	-	-	-	-
LT Domestic Bonds	-	-	-	-	-
LT Bonds	157,340	253,212	421,758.00	506,700	545,781
Real Estates	94,151	94,484	101,450	93,167	119,390
LT Equity Investment	56,296	46,485	14,243	16,345	20,467
Others	-	-	-	-	-
Total Investment Assets	1,213,267	1,378,165	1,516,182	1,634,515	1,705,566
Average Investment Assets	1,137,046	1,295,716	1,447,174	1,575,349	1,670,041
Investment Assets/Total Assets (Avg.)	94.1%	94.6%	94.0%	94.2%	93.3%

Cathay United Bank P&L					NT\$mn
Year to December	2002	2003	2004	2005E	2006E
Total interest income	29,256	24,049	31,991	37,797	42,683
Trading, dividend, investment income	1,298	2,452	1,210	1,331	1,500
Fee income	1,925	3,076	6,910	6,894	7,583
Other income	464	773	1,741	1,782	1,800
Total income	32,942	30,350	41,851	47,804	53,566
Interest expense	11,124	6,668	8,296	13,266	16,261
Trading, dividend, investment loss	297	-	-	-	-
Commision paid	242	397	428	1,293	1,423
Provision	22,778	9,026	2,548	1,612	2,582
Other expenses	2,022	3,096	1,549	1,600	1,700
Total operating cost	36,462	19,186	12,819	17,771	21,966
Operating margin bfr. provision	19,258	20,190	31,579	31,645	34,182
Operating margin	(3,520)	11,164	29,032	30,033	31,600
Total SG&A	7,249	8,512	12,503	12,628	12,818
Net operating income	(10,768)	2,653	16,528	17,405	18,782
Net non-operating income	(1,159)	-32	1,140	-500	0
Pretax income	(11,927)	2,620	17,668	16,905	18,782
Tax expense	(3,120)	(86)	3,789	3,719	4,132
Net income	(8,807)	2,706	13,879	13,186	14,650
EPS	(2.27)	0.65	3.21	2.94	3.27

Cathay United Bank Balance Sheet					NT\$mn
Year to December	2002	2003	2004	2005E	2006E
Cash	25,454	11,492	12,645	16,116	20,356
Money mkt & interbank	60,261	61,567	60,813	53,349	67,853
S/T investment	105,172	178,434	240,083	264,121	289,361
All loans	394,578	511,762	585,618	630,994	696,014
Receivables & other current assets	23,013	58,350	58,316	74,521	89,425
LT investment	12,153	26,841	37,399	41,200	42,000
Fixed assets	23,241	26,049	24,794	24,535	24,235
Other non-current assets	8,675	7,931	4,696	6,600	4,450
Total assets	652,547	882,427	1,024,365	1,111,436	1,233,694
Deposit	514,675	659,957	745,289	871,252	920,717
Interbank borrowings	59,290	107,069	129,434	86,692	136,940
Accrued expenses & other current liab.	11,583	19,087	18,437	12,226	18,505
LT liab. (check)	12,207	26,804	49,965	53,273	53,273
Special reserve & other non-current liab.	752	926	881	1,624	11,275
Total liabilities	598,506	813,843	944,005	1,025,067	1,140,711
Common Shares	39,716	43,182	43,182	46,421	46,421
Reserve	22,801	22,584	23,415	24,733	26,198
Retained Earnings	-8,583	2,764	13,879	15,302	20,363
Adjustments	107	54	(116)	(88)	-
Total Equity	54,041	68,584	80,360	86,368	92,983
Total Liabilities & Equity	652,547	882,427	1,024,365	1,111,436	1,233,694
BV	13.61	15.88	18.61	18.61	20.03
Loan/Deposit (%)	75.24	77.16	78.09	74.95	75.30
CAR %	10.79	11.15	11.69	12.63	12.17
Broad-based NPL (%)	2.96	2.88	1.38	1.35	1.35

Cathay United P&L					NT\$mn
Year to December	2002	2003	2004	2005E	2006E
Total interest income	29,256	24,049	31,991	37,797	42,683
Trading, dividend, investment income	1,298	2,452	1,210	1,331	1,500
Fee income	1,925	3,076	6,910	6,894	7,583
Other income	464	773	1,741	1,782	1,800
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Total SG&A	7,249	8,512	12,503	12,628	12,818
Net operating income	(10,768)	2,653	16,528	17,405	18,782
Net non-operating income	(1,159)	-32	1,140	-500	0
Pretax income	(11,927)	2,620	17,668	16,905	18,782
Tax expense	(3,120)	(86)	3,789	3,719	4,132
Net income	(8,807)	2,706	13,879	13,186	14,650
EPS (NT\$)	(2.27)	0.65	3.21	2.94	3.27
Cathay United Bank Balance Sheet					
Year to December	2002	2003	2004	2005E	2006E
Cash	25,454	11,492	12,645	16,116	20,356
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S/T investment	105,172	178,434	240,083	264,121	289,361
All loans	394,578	511,762	585,618	630,994	696,014
Receivables & other current assets	23,013	58,350	58,316	74,521	89,425
L/T investment	12,153	26,841	37,399	41,200	42,000
Fixed assets	23,241	26,049	24,794	24,535	24,235
Other non-current assets	8,675	7,931	4,696	6,600	4,450
Total assets	652,547	882,427	1,024,365	1,111,436	1,233,694
Deposit	514,675	659,957	745,289	871,252	920,717
Interbank borrowings	59,290	107,069	129,434	86,692	136,940
Accrued expenses & other current liab.	11,583	19,087	18,437	12,226	18,505
L/T liab. (check)	12,207	26,804	49,965	53,273	53,273
Special reserve & other non-current liab.	752	926	881	1,624	11,275
Total liabilities	598,506	813,843	944,005	1,025,067	1,140,711
Common Shares	39,716	43,182	43,182	46,421	46,421
Reserve	22,801	22,584	23,415	24,733	26,198
Retained Earnings	-8,583	2,764	13,879	15,302	20,363
Adjustments	107	54	(116)	(88)	-
Total Equity	54,041	68,584	80,360	86,368	92,983
Total Liabilities & Equity	652,547	882,427	1,024,365	1,111,436	1,233,694
BV(NT\$)	13.61	15.88	18.61	18.61	20.03
Loan/Deposit	75.24%	77.16%	78.09%	74.95%	75.30%
CAR	10.79%	11.15%	11.69%	12.63%	12.17%
Broad-based NPL	2.96%	2.88%	1.38%	1.35%	1.35%
Loan-Loss Coverage	56.31%	50.51%	84.56%	67.00%	70.00%

Cathay FHC Total Assets Controlled					NT \$mn
Year to December	2002	2003	2004	2005E	2006E
Cathay Life Insurance	1,285,559	1,454,725	1,624,722	1,721,027	1,857,815
Cathay United Bank	652,547	882,427	1,024,365	1,111,436	1,233,694
Lucky Bank	-	-	-	90,328	91,328
Cathay Century Insurance	8,867	10,279	11,659	12,279	13,079
Other Investments	-	-	4,480	4,600	4,800
Total	1,946,973	2,347,431	2,665,225	2,939,669	3,200,716

Cathay FHC P&L					NT \$mn
Year to December	2002	2003	2004	2005E	2006E
Cathay Life Insurance	12,848	16,676	15,386	13,583	12,199
Cathay United Bank	524.00	3,518.00	13,767.00	13,186	14,650
Lucky Bank	-	-	-	488	1,000
Cathay Century Insurance	-	533	588	620	800
Other Investment Income	204	(82)	(52)	-	-
Total Investment Income	13,576	20,645	29,689	27,877	28,649
Cathay Life Insurance%	94.6%	80.8%	51.8%	48.7%	42.6%
Cathay United Bank%	0.04	0.17	0.46	47.3%	51.1%
Lucky Bank%	-	-	-	1.7%	3.5%
Cathay Century Insurance%	-	2.6%	2.0%	2.2%	2.8%
Other Investment Income%	1.5%	-0.4%	-0.2%	-	-
Total Investment Income%	100.0%	100.0%	100.0%	100.0%	100.0%
Operating Expenses	727	367	383	612	918
Operating Income	12,849	20,278	29,307	27,264	27,731
Non Operating (Net)	(76)	338	549	-	-
Pretax Earnings	12,773	20,616	29,856	27,264	27,731
Tax Expense	(211)	(40)	58	-	-
Net Earnings	12,984	20,656	29,798	27,264	27,731
EPS (NT\$)	1.54	2.49	3.58	3.22	3.27
Cash DPS (NT\$)	1.50	1.19	2.00	2.50	2.25
Payout	7500.00%	77.48%	80.44%	69.78%	69.93%

Cathay FHC Balance Sheet					NT \$mn
Year to December	2002	2003	2004	2005E	2006E
Cash & Equivalent	11,336	6,323	20,472	9,442	6,451
Marketable Security	450	2,147.42	-	-	-
Total Other Current Assets	157	755	1,324	2,224	2,224
Long-term Investment	123,840	158,051	178,505	192,731	204,387
Total Other Assets	539	409	72	3,855	3,855
Total Assets	136,323	167,684	200,373	208,253	216,917
S/T Borrowings	-	-	-	-	-
Payables & Other Current Liab.	406	735	1,190	2,282	2,282
Total L/T Liab.	25,017.62	25,139	23,833	15,290	15,290
Total Liab.	25,424	25,874	25,023	17,571	17,571
Common Shares	84,532	83,075	83,167	84,742	84,742
Reserve	56,822	56,819	62,108	72,512	75,285
Retained Earnings	13,085	16,917	30,641	33,994	39,885
Others	(833)	38	(211)	(211)	(211)
Treasury Stocks	(42,706)	(15,040)	(355)	(355)	(355)
Total Equity	110,899	141,810	175,350	190,681	199,345
Total Liabilities & Equity	136,323	167,684	200,373	208,253	216,917
BV (NT\$)	13.12	17.07	21.08	22.50	23.52
RoAA (%)	11.71%	16.35%	18.79%	14.90%	14.22%
RoAE (%)	9.52%	13.59%	16.19%	13.34%	13.04%

MasterLink Securities – Stock Rating System

BUY: Total return expected to appreciate 10% or more over a 3-month period.

HOLD: Total return expected to be between 10% to –15% over a 3-month period.

SELL: Total return expected to depreciate 10% or more over a 3-month period.

Additional Information Available on Request

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