

*Earnings enhancement on the way*

**Initiate coverage BUY**

Closing price (HK\$)	0.95
12M Target price (HK\$)	2.10
52 weeks H/L	1.06/0.235

**Key data**

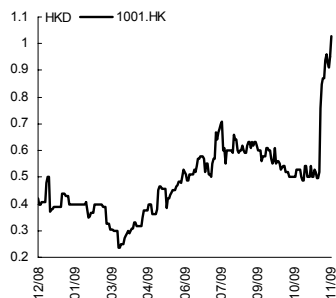
Market cap (HK\$m)	392.3
Share outstanding (mn)	413.028
FY10F PE (x)	3.65
FY10F PB (x)	0.58
FY10F ROE (%)	15.32
Major shareholders	Yao Cho Fai 45.89%

**HIS and Share performance (%)**

	1M	3M	12M
HSI	+3.91	+10.11	+75.58
VSC	+75.93	+55.74	+201.59

Source: Bloomberg, Celestial Securities Ltd

**1 YEAR PRICE**



Source: Bloomberg, Celestial Securities Ltd

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Van Shung Chong's (VSC) performance for the first half of 2009/2010 has been commendable with 46% increase of profit attributable to the equity holders at HK\$50mn from approximately HK\$34mn for the period of last year. The company has demonstrated a strong recovery of the business and profitability in tandem with the large number of infrastructure projects rolled out and robust growth on both automobile and property sector in China after its performance was severely affected by global financial crisis in 2008. We are optimistic about the company's future prospect and risk control capability, and expect its profitability level will improve further in the second half. We initiate coverage on VSC with BUY recommendation with 12 months target price of HK\$2.10, implies 8 times forward PE for 2010F.

↑ **Turnaround in first-half performance.** VSC's profit attributable to equity holders rose 46% to HK\$50mn for the first half of 2009/2010 from HK\$34mn a year earlier after sales of building materials and steels products were severely impacted by the economic crisis. It shows a recovery of the business and profitability when compared with the loss incurred for the first three months of 2009, and the key drivers is largely attributed to the high operating efficiency and comprehensive cost reduction program. The fast turnaround signaled the overall market demand has apparently pick-up and thereby reducing the group's financial and operating risks.

↑ **Looking for an improvement for steel demand.** Steel distribution operations contributed approximately 80% of the company's total revenue. Therefore, it has a significant impact to the company's overall performance after the global steel prices were experiencing dramatic fall in early 2009. However, we believe that the steel prices had bottomed out and prices are now comparatively stable and demand is also gradually increasing with the various infrastructure and construction projects launching out and recovery in property sector. We expect the company's earnings per share will improve to HK\$0.26, HK\$0.33 and HK\$0.39 for 2010F, 2011F and 2012F respectively.

↑ **Benefiting from the massive infrastructure and construction projects launching out.** The principal activities of VSC are mainly involved in distributing of steel products in Hong Kong and China. The company maintained 40% market share currently in Hong Kong market to supply to various projects and customer base has also been further widened. We believe the demand of steel will further increase along with the large number of infrastructure and construction projects, which provides a prosperous market to the company. We expect the company's revenue will grow by at least 10% next year.

↑ **We recommend Buy on TP of HK\$2.10 due to upbeat outlook for 2010F.** We expect a healthy outlook for 2010F with primary drivers include growing domestic demand driven by government stimulus and recovery on property market. Based on our free cash flow valuation model with assumption that the sustainable growth rate of 3% and 10.44% of cost of capital, we expect the fair value for the company is at HK2.08, which gives a potential upside of 126% against the current price at HK\$0.95.

**Key financials**

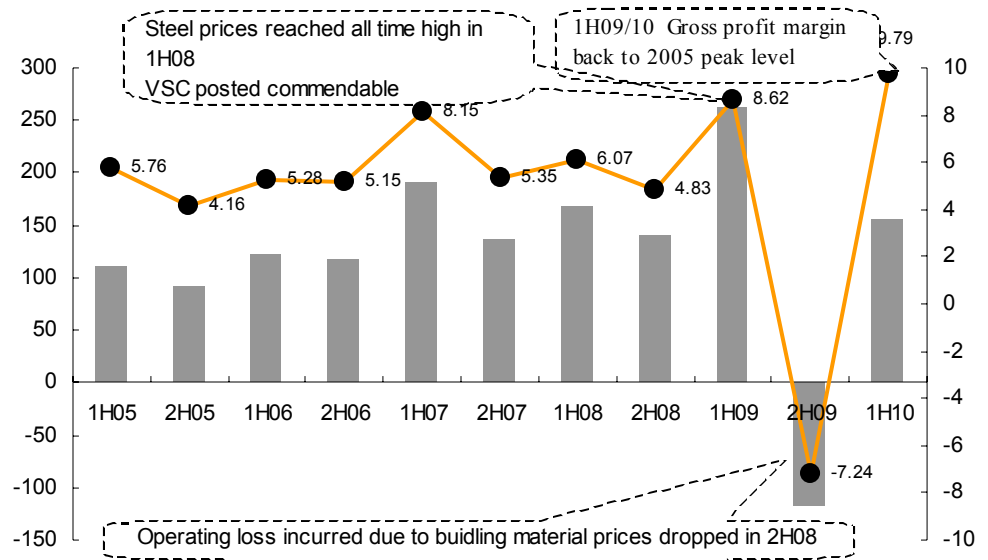
Year end 31/3	2008A	2009A	2010F	2011F	2012F
Sales revenue (HK\$m)	5677.79	4659.51	3210.56	3547.67	3895.34
Net profit (HK\$m)	31.32	-278.25	101.77	128.78	152.31
EPS (HK\$)	0.08	-0.73	0.26	0.33	0.39
EPS growth (%)	-56.73	-980.70	NA	26.53	18.27
PE (x)	11.22	-1.27	3.65	2.87	2.43
ROE (%)	2.91	-49.55	15.32	16.25	18.47

Source : Company data & Celestial Securities Ltd

**Turnaround in 2009 / 2010 fiscal year**

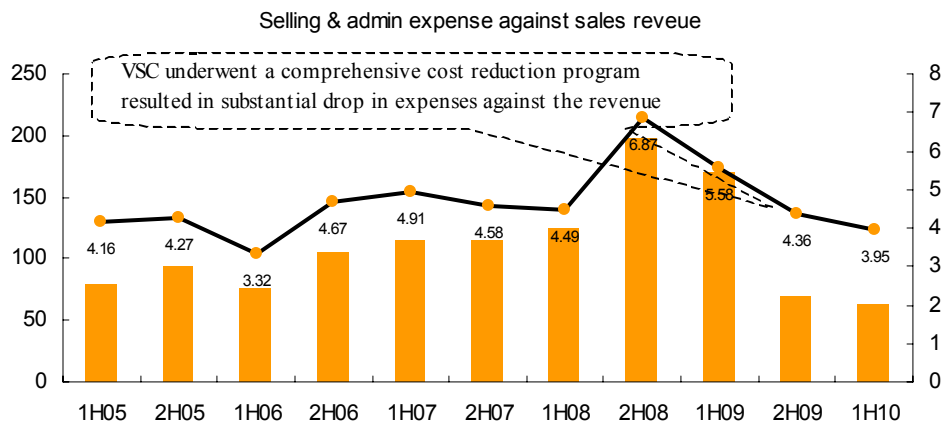
VSC's profit attributable to equity holders rose 46% to HK\$50mn for first half of 2009/2010 from HK\$34mn a year earlier after sales of building materials and steels products were severely impacted by the economic crisis. It shows a recovery of the business and profitability when compared with the loss incurred for the first three months of 2009, and the key drivers is largely attributed to the high operating efficiency and comprehensive cost reduction program, of which selling and distribution expenses decreased by 61% during the period. In addition, general and administrative expenses also went down by 51%. The fast turnaround signaled the overall market demand has apparently pick-up and thereby reducing the group's financial and operating risks. Inventory turnover improved to 29 days as compared to 43 days for the period of last year.

**Figure 1 – 1<sup>st</sup> half gross profit margin reached 2005 peak level**



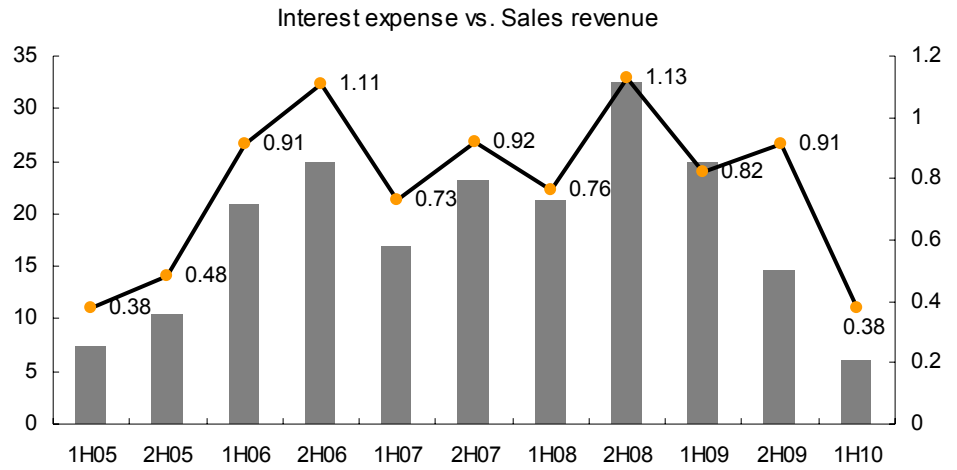
Source: Company data & Celestial Securities Ltd

**Figure 2- Comprehensive cost reduction program**



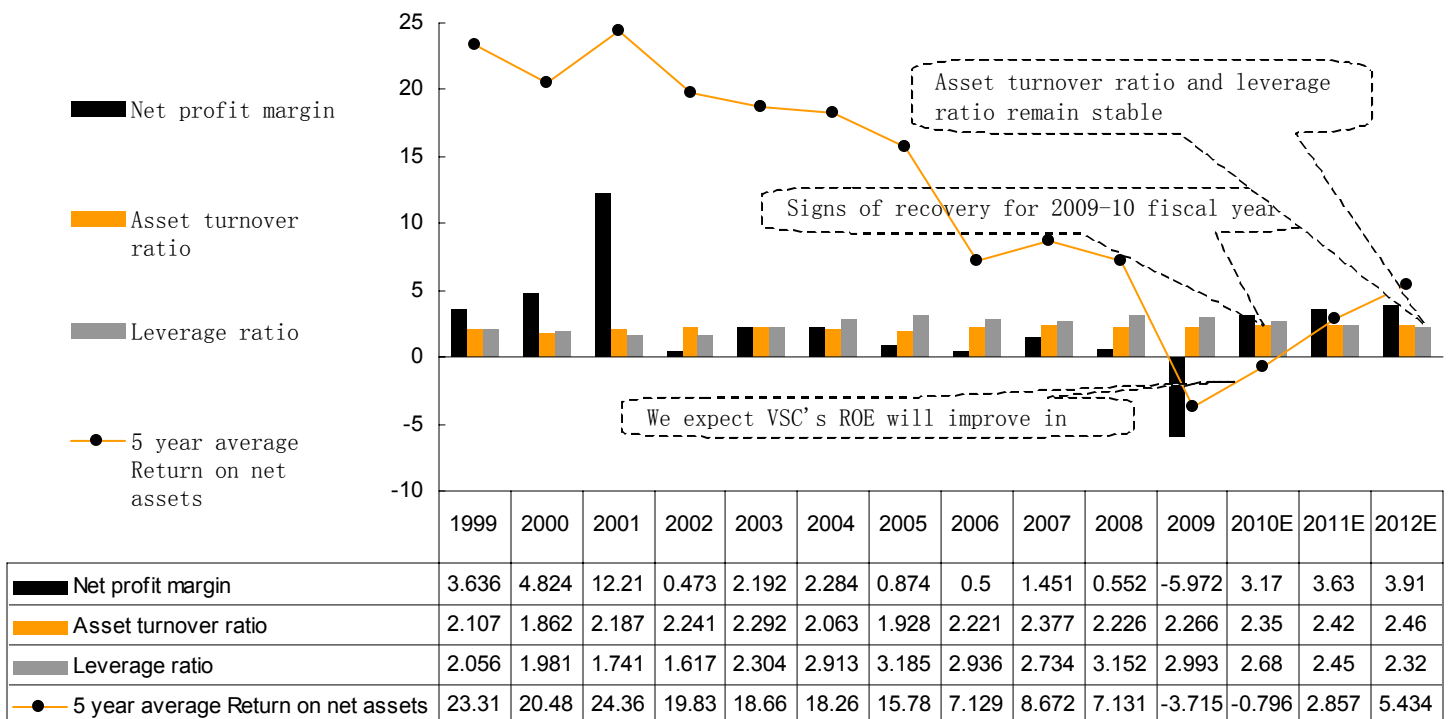
Source : Company data & Celestial Securities Ltd

Figure 3- VSC's interest expense vs. sales revenue



Source: Company data & Celestial Securities Ltd

Figure 4-Dupont Analysis



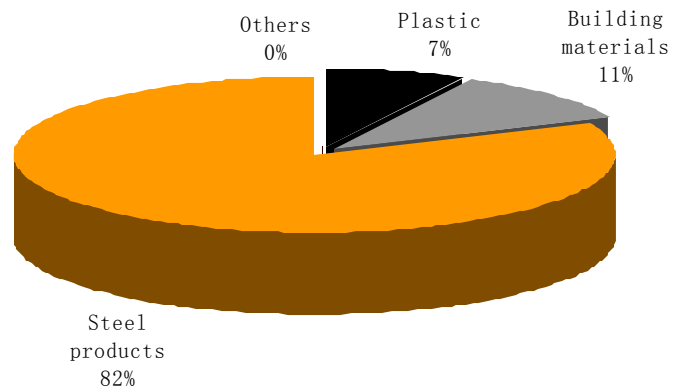
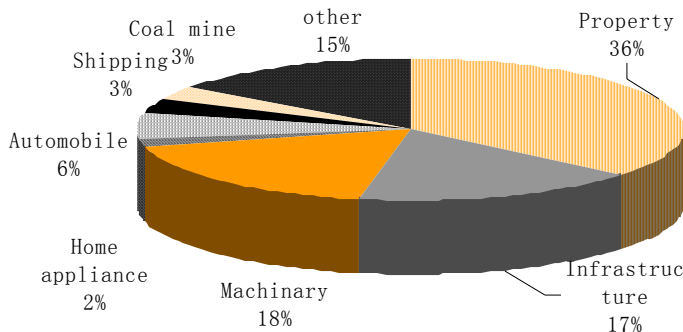
Source: Company data & Celestial Securities Ltd

**Looking for an improvement for steel demand**

Steel distribution operations contributed approximately 80% of the company's total revenue. Therefore, it has a significant impact to the company's overall performance after the global steel prices were experiencing dramatic fall in the month of September 2009. However, we believe that the steel prices had bottomed out and prices are now comparatively stable and demand is also gradually increasing with the various infrastructure and construction projects launching out and recovery in property and automobile sector. Although the steel prices remain under pressure due to overproduction and high inventories, we expect the earnings growth will further improve along with destocking started to take place and a sustainable steel industry recovery.

Figure 5 – Steel consumption breakdown by sectors

Figure 6 – Sales revenue breakdown

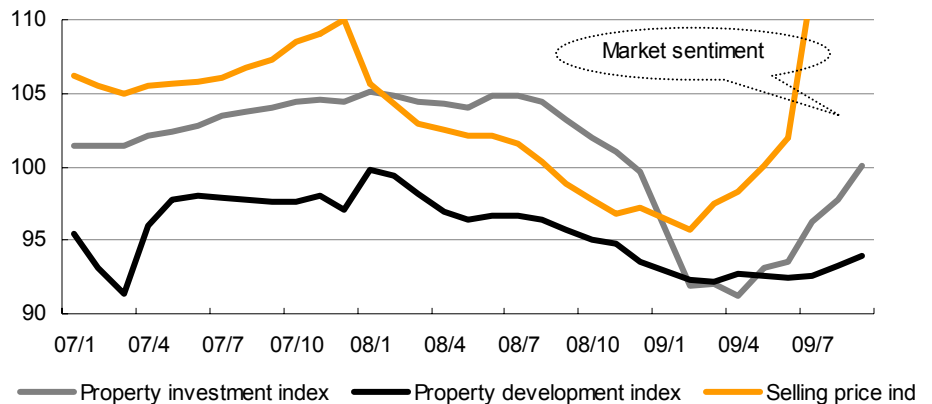


Source: China Iron & Steel Association, Company data, Celestial Securities Ltd

**Strong demand from property sector**

Benefiting from the loose monetary policy, property market has been demonstrated a strong rebound since February this year. As at September 2009, the property market in mainland has surged for the last five months with the property development investment index surpassed 100, while the selling price index reached 114.38, the new high in three year.

Figure 7 – Property sector indices



Source: bloomberg, Celestial Securities Ltd

With the various government around the world have implemented a series of economy stimulation actions, China's housing sales have recorded a substantial increase since March this year especially in the first-tier cities like Beijing and Shanghai. Apparently, property developers are generally positive with a sustainable recovery on property sector, which has resulted in higher investment on property development. As at September 2009, total investment on property development in China grow 37% to Rmb2.505 trillion, backed to the highest level in June 2008, as compared t the previous corresponding period.

Meanwhile, new housing starts have also increased along with the substantial surge in sales areas and commercial properties. As at September this year, the total areas for new housing had reached 2.77bn square meters, of which 150mn square meters was recorded in September alone, which represents an increase of 15.4% and 66% respectively as compared with the previous corresponding period. Therefore, we believe the demand on steels will continue to increase in view that steel is one of the major component s for housing development.

Figure 8 – Total property investment in China

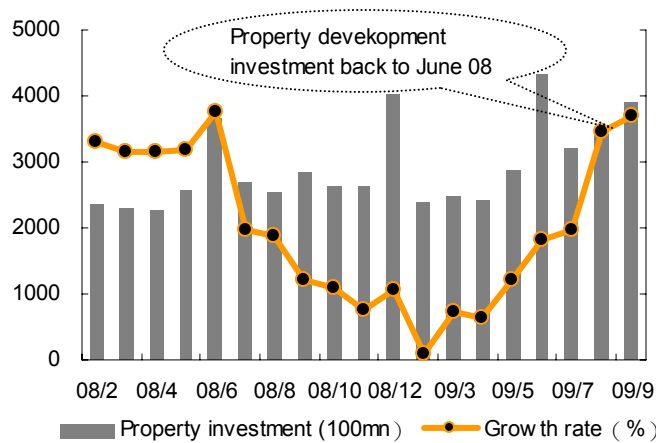


Figure 9 – Total sales areas for new housing

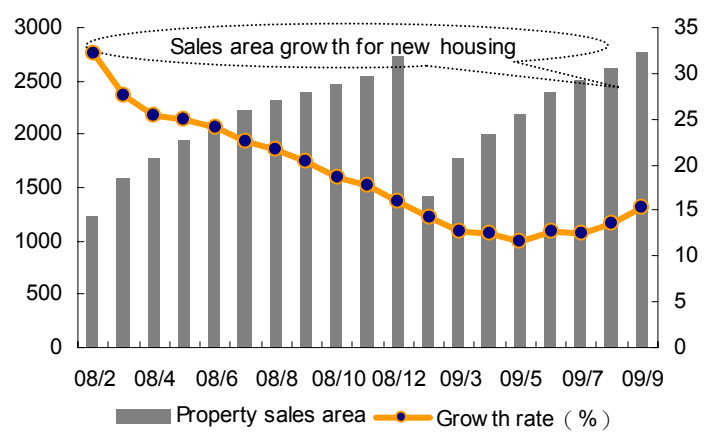


Figure 10 – Total sales areas for commercial property

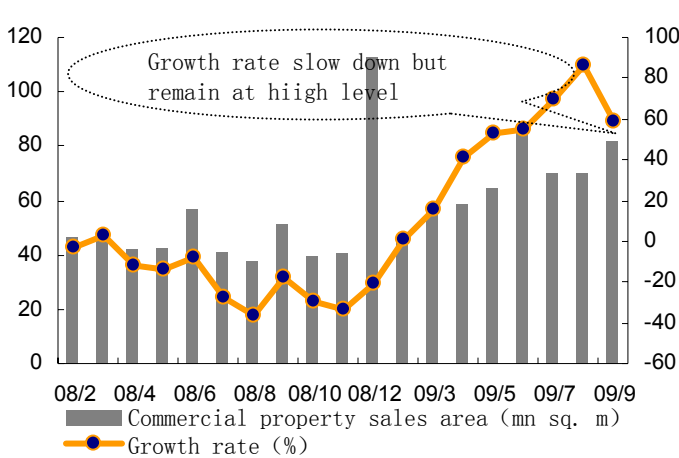
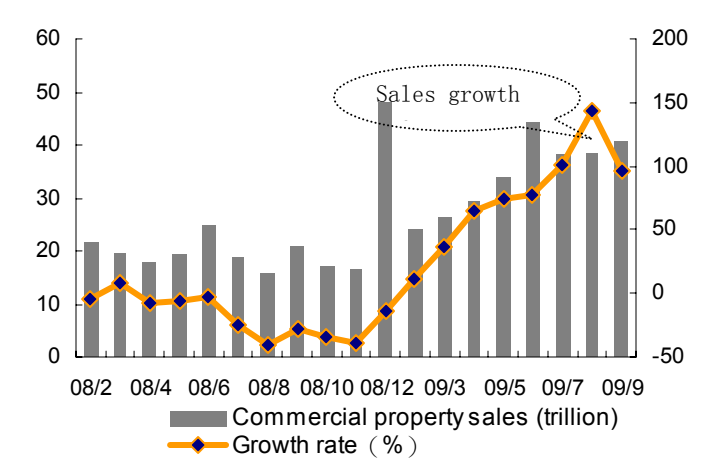


Figure 11 – Total sales(y-o-y) for commercial property



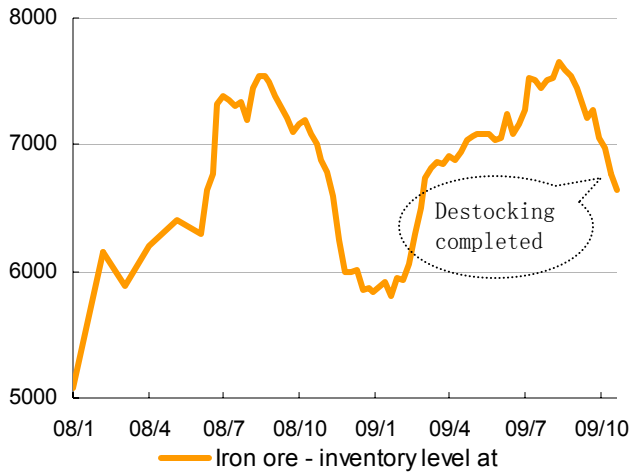
Source: National Bureau of Statistic, bloomberg, Celestial Securities Ltd

**Signs of stabilizing for steel prices**

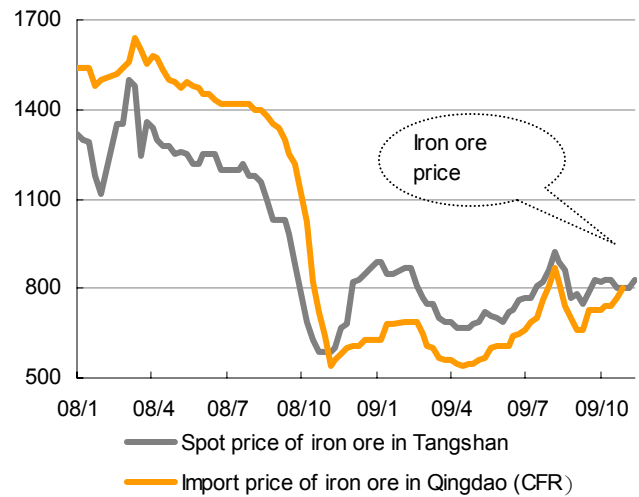
We believe the iron ore, coke and other raw materials prices will continue to increase and thereby lifting the overall production cost in 2010. Therefore, we do not expect to see any downside risk on steel prices moving forward, in our view.

Steel prices underpinned by higher production cost. Commodities prices has since rebounded amid global economic recovery with iron ore, coke prices are showing signs of stabilizing, signaling the earlier weakness was finally over. Iron ore price has bottomed out in the month of August and rose to US\$800 per ton level.

**Figure 12 – Inventory level for Iron ore (10,000 tons)**



**Figure 13– Iron ore price movement (Rmb/ton)**



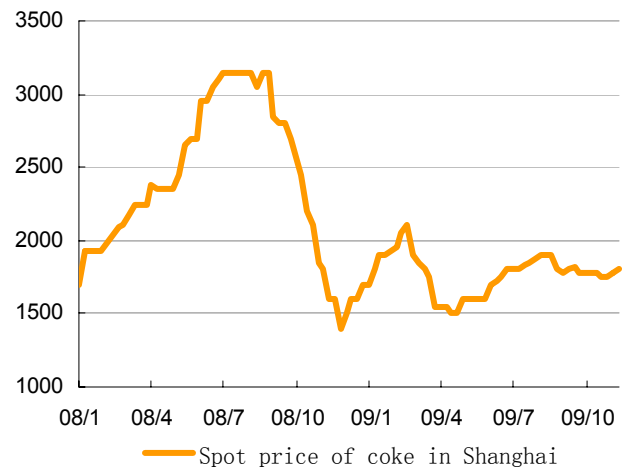
Source: bloomberg, Celestial Securities Ltd

Meanwhile, the sea freight for raw materials had rebounded, and recorded 40% increase over the last two weeks, marking the highest in three months time.

**Figure 14–BDI Index**



**Figure 15–Coke price movement (RMB/ton)**

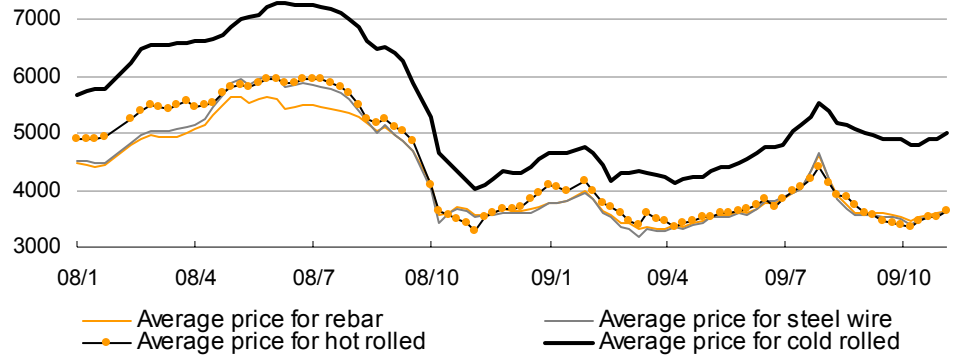


Source: bloomberg, Celestial Securities Ltd

**Destocking will lift the steel price higher**

Destocking is expected to accelerate in view of the higher demand from the downstream sector. Steel prices will remain under pressure due to overproduction in the earlier period, but we reckon that it will improve once the destocking process has been completed.

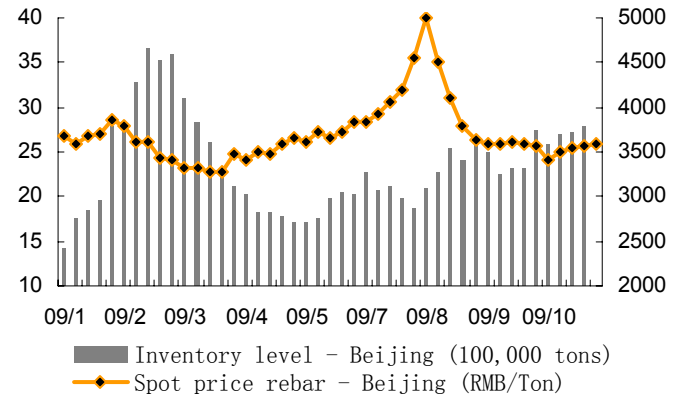
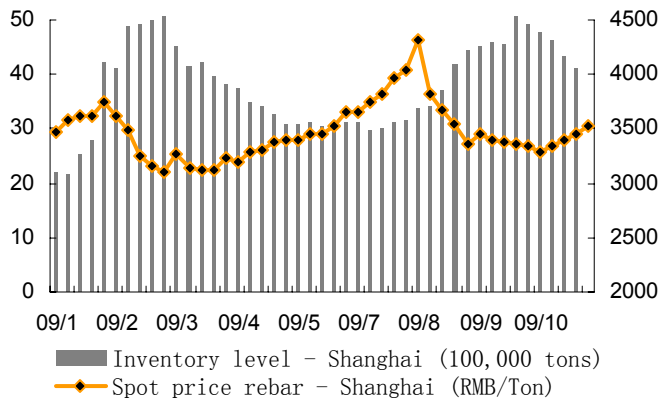
**Figure 16–Steel products prices trend (RMB/ton)**



Source: bloomberg, Celestial Securities Ltd

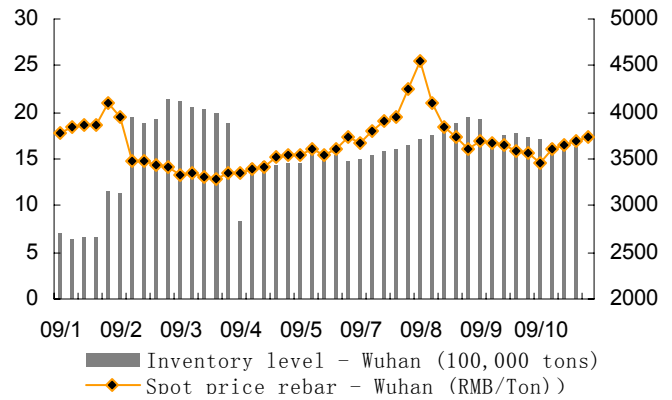
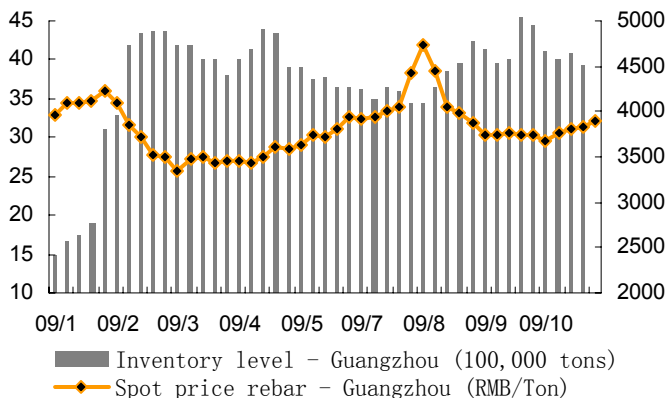
**Figure 17–Inventory and steel prices (Shanghai)**

**Figure 18 – Inventory level and steel prices (Beijing)**



**Figure 19 – Inventory and steel prices (Guangzhou)**

**Figure 20 –Inventory level and steel prices (Wuhan)**

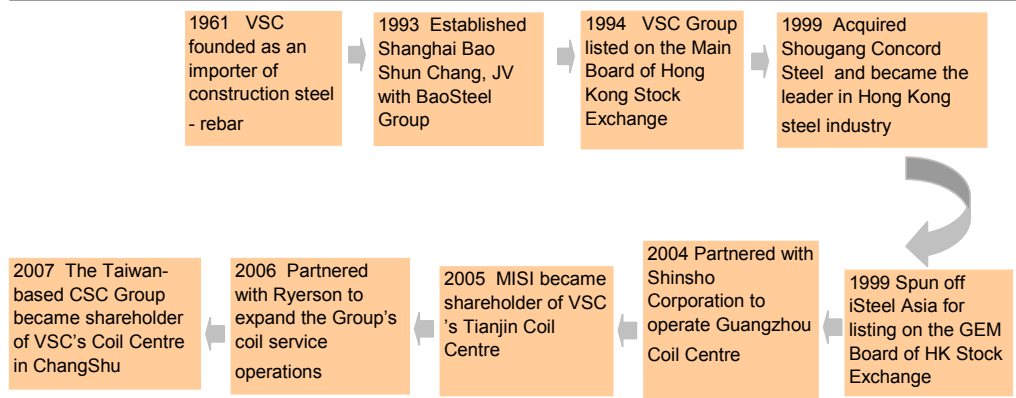


Source: bloomberg, Celestial Securities Ltd

**Benefiting from the massive infrastructure and construction projects launching out**

The principal activities of VSC are mainly involved in distributing of steel products in Hong Kong, Shenzhen and Shanghai. The company maintained 40% market share currently in Hong Kong market to supply to various projects and customer base has also been further widened. We believe the demand of steel will further increase along with the large number of infrastructure and construction projects such as Shanghai World Expo 2010, Shanghai Disney and etc, which provides a prosperous market to the company.

**Figure 21 – Key milestones**



Source: Company data. Celestial Securities Ltd

**Upcoming infrastructure development in Hong Kong**

Infrastructure and construction sector in Hong Kong has ground to a halt since year 2000 until the Chief Executive's policy address in 2007 on promoting the 10 major infrastructure projects during his five years tem (2007-2012) but it has since been deferred due to global economic crisis. With the economic is now on track to recovery along with the resumption of the 10 major infrastructure project to be roll out over the next three years, we expect it will set to increase the steel consumption and thereby benefiting VSC as a whole foe being the largest five steel suppliers in Hong Kong.

**Table 1: HK Government 10 infrastructure projects**

	Duration	Project
<b>Transport Infrastructure</b>	2011-2015	South Island Line
	2012-2019	The Sha Tin to Central Link
	2011-2016	The Tuen Mun Western bypass and Tuen-Chep Lap Kok Link
<b>Cross-boundary Infrastructure</b>	2009-2014/2015	The Guangzhou-Shenzhen-HK ERL
	2009-2015	HK-Zhuhai-Macau Bridge
	2010Start	HK-Shenzhen Airport Co-operation
<b>New Urban Development Areas</b>	2015 Start	HK-Shenzhen Joint Development of the Lok Ma Chau Loop
	2009-2014/2015	West Kowloon Cultural District
	2009-2013	Kai Tak Development Plan
	2009-2013	New Development Areas (NDAs)

Sources: Hong Kong Chief Executive's policy address, Celestial Securities Ltd



**Upcoming infrastructure development in Shanghai and Shenzhen**

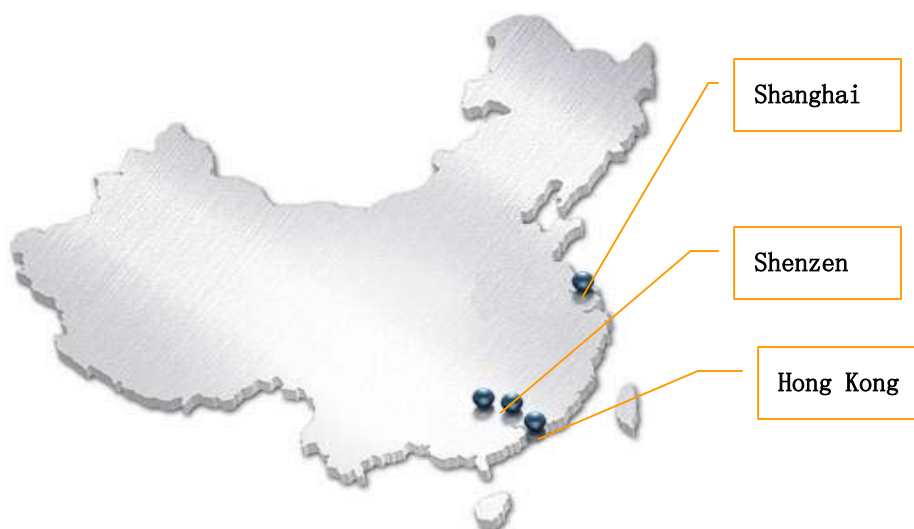
VSC has a 66.7% owned joint venture, Shanghai Bao Shung Chang established in 1993 with Bao Steel Group, which engages in the distribution of domestic steel products in Shanghai and Shenzhen since 90s. Benefiting from the construction of Shanghai World Expo 2010, VSC has reported 30% growth on sales in Shanghai for the first six months ended 30 September. With more infrastructure and construction projects on the pipeline to be rolled-out by the government, we believe it will provide a prosperous market with a sustainable growth in the near future.

**Table 2: Upcoming major infrastructure projects in China**

Project area	Duration	Project
Shanghai	2009-2010	2010 Shanghai World Expo
	2010 Start	Shanghai Disney
	2009-2012	Shanghai International Centre – Economic, Financial, Trade and Shipping
	Work in progress	Subway construction and Yangtze tunnel
Shenzhen	2011-2030	24 new lines (total length 830.7 km)
	2009-2014/15	The Guangzhou-Shenzhen-HK ERL
	2010 Start	HK-Shenzhen Airport Co-operation
	2015 Start	HK-Shenzhen Joint Development of the Lok Ma Chau Loop
	2005-2018	7 straight and 13 horizontal Highways Network

Source: Celestial Securities Ltd

**Figure 22 – VSC’s main distribution areas**



Source: Company data. Celestial Securities Ltd

### Valuation is substantially undervalued

The fast turnaround signaled the overall market demand has apparently pick-up and thereby reducing VSC's financial and operating risks. Meanwhile, we believe VSC is likely to benefit from the upcoming infrastructure and construction projects both in Hong Kong and China thereby lead to a sustainable growth from higher steel and building materials consumption. We expect the company's earnings will improve by at least 10% if not better next year. However, if we compare VSC with other steel traders, building materials sellers and others, its valuation is relatively inexpensive and trade at 3.65x PE even with the higher gross profit margin and earnings per share growth. We are positive about the company's future prospect with further upside potential.

Table 3—Peers valuation

Company/Stock code	Market cap. HK\$ mn	YTD yield (%)	GP margin (%)	ROE	EV/ EBITDA	P/E	P/S	P/CF	Turnover growth	EPS growth
<b>Iron and Steel production</b>										
Golik Holding/1118.HK	201.41	82.72	3.95	13.36	6.05	6.71	0.06	0.63	-7.71	-38.27
Asia Tele-Net/679.HK	174.85	83.11	-16.38	-6.72	22.86	8.60	0.75	4.57	-0.07	-124.30
Citic Pacific/267.HK	77717.06	157.15	10.23	-23.07	27.63	15.19	1.66	19.70	-30.37	-248.18
Mayer Holdings/1116.HK	408.96	32.73	-1.95	-27.77	NA	NA	0.85	NA	-57.61	-202.06
Industry average	19625.57	88.93	-1.04	-11.05	18.85	10.17	0.83	8.30	-23.94	-153.20
Industry median	305.19	82.92	1.00	-14.90	22.86	8.60	0.80	4.57	-19.04	-163.18
<b>Iron and Steel trade</b>										
Burwill/24.HK	1694.03	1417.17	-1.97	-19.10	29.37	NA	0.21	NA	-19.64	-241.02
Lung Kee/255.HK	2521.99	103.03	14.82	11.79	3.81	8.55	0.93	4.64	-15.19	-40.59
<b>VAN Shung Chong/1001.HK</b>	<b>384.12</b>	<b>342.08</b>	<b>9.79</b>	<b>8.57</b>	<b>2.85</b>	<b>3.65</b>	<b>0.23</b>	<b>1.01</b>	<b>-46.14</b>	<b>41.76</b>
Industry average	1533.38	620.76	7.55	0.42	12.01	7.88	0.46	2.83	-26.99	-79.95
Industry median	1694.03	342.08	9.79	8.57	3.81	7.88	0.23	2.83	-19.64	-40.59
<b>House BM</b>										
Royale Furn/1198.HK	569.48	235.69	9.60	-16.91	6.63	NA	0.69	NA	-19.18	-275.44
Chinavision/1060.HK	600.04	64.59	2.52	-64.93	15.86	NA	0.67	NA	14.83	-155.52
TCC Int'L Hold/1136.HK	4484.33	77.60	-1.14	-7.20	34.75	8.14	0.62	7.54	38.22	94.20
Paul Y.Eng/577.HK	393.90	63.35	0.67	7.58	10.03	9.34	0.08	NA	-9.89	-66.93
Industry average	1511.94	110.31	2.91	-20.37	16.82	8.74	0.52	7.54	6.00	-100.92
Industry median	584.76	71.09	1.60	-12.06	12.95	8.74	0.65	7.54	2.47	-111.23

Source: bloomberg, Celestial Securities Ltd

**Free cash flow valuation**

We expect the company's earnings per share will improve to HK\$0.26, HK\$0.33 and HK\$0.39 for 2010F, 2011F and 2012F respectively in view of the massive infrastructure and construction projects to be rolled-out and strong recovery on both automobile and property sector in China. Based on our free cash flow valuation model with assumption that the sustainable growth rate of 3% and 10.44% cost of capital, we expect the fair value for the company is at HK2.08 against the current price at HK\$0.95. Valuation is undemanding, and gives a substantial upside in the near future. We recommend Buy with target price set at HK\$2.10, implying 8 times forward PE for 2010F.

**Table 4—Free cash flow valuation**

	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E
Turnover	3210.56	3547.67	3895.34	4284.87	4713.36	5184.70	5703.17	6273.48	6900.83	7590.92
NP	101.77	128.78	152.31	128.55	141.40	155.54	171.10	188.20	207.02	227.73
Dep & Amor	10.13	11.00	8.76	9.64	10.61	11.67	12.83	14.12	15.53	17.08
WCInv.	70.53	77.51	85.11	93.79	104.20	114.93	129.07	143.01	160.03	176.03
CFO	41.38	62.27	75.96	44.40	47.81	52.27	54.86	59.31	62.52	68.78
Cap. exp.	10.00	10.10	10.27	10.36	10.45	10.57	10.67	10.76	10.78	10.80
Net borrowing	15.00	16.20	17.17	17.94	19.20	20.35	21.41	22.37	23.23	24.15
FCFE	46.38	68.37	82.86	51.98	56.55	62.06	65.60	70.92	74.97	82.13

Source: bloomberg, Celestial Securities Ltd

**Table 5—Free cash flow valuation sensitivity analysis**

Value per share (HK\$)	4%	3.5%	g(c)=3%	2.5%	2%
9.94%	2.16	2.15	2.15	2.14	2.14
9.44%	2.24	2.23	2.23	2.22	2.21
r(e)=10.44%	2.09	2.08	2.08	2.07	2.07
10.94%	2.02	2.01	2.01	2.00	2.00
11.44%	1.95	1.94	1.94	1.94	1.93

Source: bloomberg, Celestial Securities Ltd

Table 6—Consolidated Income Statement

Year-end Mar, HK\$ mn	2007	2008	2009	2010E	2011E	2012E
<b>Turnover</b>	<b>4867.66</b>	<b>5677.79</b>	<b>4659.51</b>	<b>3210.56</b>	<b>3547.67</b>	<b>3895.34</b>
COGS	4549.89	5370.77	4513.74	2949.86	3267.40	3609.81
<b>Gross profit</b>	<b>317.76</b>	<b>307.02</b>	<b>145.76</b>	<b>260.70</b>	<b>280.27</b>	<b>285.53</b>
SG%A	229.09	272.84	240.46	149.21	160.35	170.62
Trading	88.68	34.18	-94.70	-52.24	0.00	0.00
Interest Inc/expense	41.38	46.82	39.54	26.01	22.00	26.49
<b>EBT</b>	<b>93.45</b>	<b>47.05</b>	<b>-256.74</b>	<b>102.89</b>	<b>131.13</b>	<b>156.31</b>
Tax	12.53	1.88	-6.55	1.11	2.35	4.00
<b>NP</b>	<b>70.63</b>	<b>31.32</b>	<b>-278.25</b>	<b>101.77</b>	<b>128.78</b>	<b>152.31</b>
<b>EPS basic, HK\$</b>	<b>0.19</b>	<b>0.08</b>	<b>-0.73</b>	<b>0.26</b>	<b>0.33</b>	<b>0.39</b>

**Efficiency**

AR turnover	6.33	7.14	18.12	11.54	12.23	13.37
Inv. Turnover	7.69	6.57	17.33	11.77	11.21	11.43
AP turnover	15.11	13.38	55.26	19.28	17.22	14.57

**Profitability**

gross margin	6.53%	5.41%	3.13%	8.12%	7.90%	7.33%
SG&A margin	4.71%	4.81%	5.16%	4.65%	4.52%	4.38%
Interest expense margin	0.85%	0.82%	0.85%	0.81%	0.62%	0.68%
EBT margin	1.92%	0.83%	-5.51%	3.20%	3.70%	4.01%
Net margin	1.45%	0.55%	-5.97%	3.17%	3.63%	3.91%
ROA	3.14%	1.10%	-22.10%	7.45%	8.78%	9.62%
ROE	7.01%	2.91%	-49.55%	15.32%	16.25%	18.47%

**Growth momentum**

Turnover growth	6.40%	16.64%	-17.93%	-31.10%	10.50%	9.80%
NP growth	209.00%	-55.66%	-988.50%	N/A	26.53%	18.27%
EPS growth	0.00%	-56.73%	-980.70%	N/A	26.53%	18.27%

Source: bloomberg, Celestial Securities Ltd

Consolidated Balance sheet

Year-end Mar, HK\$ mn	2007	2008	2009	2010E	2011E	2012E
Cash and eq.	304.57	271.44	100.68	261.00	279.00	323.00
Non-current assets held for sale	0.00	0.00	0.00	0.00	0.00	0.00
AR	769.35	794.80	257.19	278.13	290.13	291.46
Inventories	591.81	818.08	260.40	250.54	291.47	315.69
other current assets	249.49	540.75	283.08	204.92	211.03	328.72
<b>Total current assets</b>	<b>1915.23</b>	<b>2425.06</b>	<b>901.34</b>	<b>994.59</b>	<b>1071.63</b>	<b>1258.86</b>
Long term investments	12.99	7.06	0.58	0.39	0.00	0.00
Net PP&E	202.84	212.64	61.15	91.18	98.98	78.88
<b>Total non-current assets</b>	<b>333.47</b>	<b>427.87</b>	<b>357.98</b>	<b>371.61</b>	<b>394.35</b>	<b>324.61</b>
<b>total assets</b>	<b>2248.69</b>	<b>2852.92</b>	<b>1259.32</b>	<b>1366.20</b>	<b>1465.98</b>	<b>1583.47</b>
AP	301.03	401.42	81.69	153.00	189.78	247.84
ST debt	683.69	1065.04	489.42	403.50	328.45	314.02
Other current liability	163.35	186.01	111.86	106.56	112.15	126.04
<b>Total current liability</b>	<b>1148.07</b>	<b>1652.47</b>	<b>682.96</b>	<b>663.06</b>	<b>630.37</b>	<b>687.90</b>
LT debt	27.30	117.69	11.65	31.36	34.12	61.64
other non-current liability	65.92	4.86	3.18	7.36	9.07	9.21
<b>Total non-current liability</b>	<b>93.22</b>	<b>122.55</b>	<b>14.82</b>	<b>38.71</b>	<b>43.19</b>	<b>70.85</b>
<b>Total liability</b>	<b>1241.29</b>	<b>1775.02</b>	<b>697.78</b>	<b>701.77</b>	<b>673.56</b>	<b>758.75</b>
<b>Total equity</b>	<b>1007.40</b>	<b>1077.90</b>	<b>561.54</b>	<b>664.42</b>	<b>792.42</b>	<b>824.72</b>

Liquidity

current ratio	167%	147%	132%	150%	170%	183%
Quick ratio	94%	65%	52%	81%	90%	89%
Cash ratio	27%	16%	15%	39%	44%	47%

Source: bloomberg, Celestial Securities Ltd

## Our Rating System

### Stock pick

Buy	Expected to outperform the benchmark index by >15% over the next six months
Accumulate	Expected to outperform the benchmark index by 5 – 15 % over the next six months
Hold	Expected to outperform or underperform the benchmark index by <5% over the six months
Reduce	Expected to underperform the benchmark index by 5 – 15% over the next six months
Sell	Expected to underperform the benchmark index by >15% over the next six months

### Sector

Outperform	Fundamentals/valuations of most stocks in the sector are expected to be improving over the next six months.
Neutral	Fundamentals/valuations of most stocks in the sector are expected to be steady, neither improving nor deteriorating, over the next six months.
Underperform	Fundamentals/valuations of most stocks in the sector are expected to be deteriorating over the next six months.
Selective	Fundamentals/valuations of the stocks in the sector are expected to be diverging over the next six months.

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