May 7, 2010

WELLS FARGO SECURITIES

# *Equity Research*

## Market Close Packet

## Contents



Together we'll go far

# *Summary* – Market Close Packet

## Earnings Estimate Revised Up

| | | | | Earnings Estimates FY2010 | | FY2011 | | FY2012 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Company** | **Price** | **M.Cap (MMs)** | **Rating** | **Old** | **New** | **Old** | **New** | **Old** | **New** | **Valuation Range** | **Analyst /Industry** |
| Devon Energy Corporation(DVN) | $65.34 | $29,272.3 | 1/V | $5.92 | $6.31 | $7.31 | $7.36 | NE | NE | $88.00-$92.00 | Tameron/**Energy** |
| El Paso Pipeline Partners, L.P.(EPB) | $25.97 | $3,511.1 | 2/V | $2.05 | $2.19 | $2.14 | $2.19 | NE | NE | $25.00-$27.00 | Blum/**Energy** |
| Encore Energy Partners, L.P.(ENP) | $17.43 | $789.6 | 1/V | $2.53 | $2.56 | NE | $2.57 | NE | NE | $21.00-$23.00 | Blum/**Energy** |
| Western Gas Partners, L.P.(WES) | $22.05 | $1,400.2 | 2/V | $1.82 | $1.85 | NE | $1.84 | NE | NE | $21.00-$23.00 | Lui/**Energy** |
| Warner Chilcott Ltd.(WCRX) | $24.51 | $6,188.8 | 1/V | $3.32 | $3.34 | NE | | NE | NE | $28.00-$30.00 | Tong/**Health Care** |
| MetroPCS Communications Inc.(PCS) | $8.06 | $2,874.2 | 2/V | $3.19 | $2.98 | $3.55 | $3.57 | NE | NE | $8.00-$8.50 | Fritzsche/**Media & Telecommunications** |
| ExlService Holdings, Inc.(EXLS) | $16.11 | $468.8 | 2/V | $0.56 | $0.69 | $0.68 | $0.81 | NE | NE | $18.00-$19.00 | Caso/**Technology & Services** |
| SRA International, Inc.(SRX) | $21.21 | $1,204.7 | 2/V | $1.26 | NC | $1.37 | $1.40 | NE | NE | $19.00-$21.00 | Caso/**Technology & Services** |
| Verisk Analytics, Inc.(VRSK) | $28.00 | $5,306.0 | 2/V | $1.33 | $1.35 | $1.48 | $1.52 | NE | NE | $30.00-$32.00 | Willi/**Technology & Services** |

## Earnings Estimate Revised Down

| | | | | Earnings Estimates FY2010 | | FY2011 | | FY2012 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Company** | **Price** | **M.Cap (MMs)** | **Rating** | **Old** | **New** | **Old** | **New** | **Old** | **New** | **Valuation Range** | **Analyst /Industry** |
| Energy Transfer Partners, L.P.(ETP) | $45.10 | $8,528.4 | 1 | $3.90 | $3.59 | $4.41 | $4.01 | NE | NE | $51.00-$55.00 | Blum/**Energy** |
| PartnerRe Ltd.(PRE) | $73.18 | $6,044.7 | 1 | $6.87 | $6.40 | $10.30 | $10.20 | NE | NE | $86.00-$92.00 | Hall/**Financial Services** |
| Leap Wireless International Inc.(LEAP) | $16.78 | $1,136.0 | 2/V | $7.98 | $7.81 | $9.65 | $9.08 | NE | NE | $17.00-$18.00 | Fritzsche/**Media & Telecommunications** |
| MetroPCS Communications Inc.(PCS) | $8.06 | $2,874.2 | 2/V | $3.19 | $2.98 | $3.55 | $3.57 | NE | NE | $8.00-$8.50 | Fritzsche/**Media & Telecommunications** |
| Pebblebrook Hotel Trust(PEB) | $18.67 | $378.3 | 1/V | $0.14 | $0.07 | $1.95 | $1.41 | NE | NE | $20.00-$23.00 | Donnelly/**Real Estate, Gaming, And Lodging** |

All securities priced at previous day's close.

May 7, 2010

# *Summary* - Market Close Packet

## Company Research Notes

| Company | Price | M.Cap (MMs) | Rating | Title | Valuation Range | Analyst /Industry |
|---|---|---|---|---|---|---|
| Aqua America(WTR) | $17.55 | $2,392.1 | 2 | WTR: In-line Q1; Focus On Pending PA And NJ Rate Cases | $17.00-$18.00 | Kalton/**Energy** |
| Devon Energy Corporation(DVN) | $65.34 | $29,272.3 | 1/V | DVN: Raising Estimates For 10-Q | $88.00-$92.00 | Tameron/**Energy** |
| El Paso Pipeline Partners, L.P.(EPB) | $25.97 | $3,511.1 | 2/V | EPB: Q1 Results Beat Estimates--Raising Estimates/Valuation | $25.00-$27.00 | Blum/**Energy** |
| Encore Energy Partners, L.P.(ENP) | $17.43 | $789.6 | 1/V | ENP: Q1 Operating Results In Line--Raising Estimates | $21.00-$23.00 | Blum/**Energy** |
| Energy Transfer Partners, L.P.(ETP) | $45.10 | $8,528.4 | 1 | ETP: Q1 DCF In Line With Forecast--Lowering Estimates | $51.00-$55.00 | Blum/**Energy** |
| Exterran Partners, L.P.(EXLP) | $22.44 | $428.6 | 1/V | EXLP: Q1 In Line With Full-Quarter Benefit From Dropdown | $25.00-$27.00 | Lui/**Energy** |
| Westar Energy, Inc.(WR) | $22.16 | $2,446.5 | 1 | WR: Bests Q1 Expectations On Strong Sales Growth | $24.00-$25.00 | Kalton/**Energy** |
| Western Gas Partners, L.P.(WES) | $22.05 | $1,400.2 | 2/V | WES: Q1 2010 Results Slightly Above Forecast--Raising Estimates | $21.00-$23.00 | Lui/**Energy** |
| PartnerRe Ltd.(PRE) | $73.18 | $6,044.7 | 1 | PRE: Conference Call Round-Up | $86.00-$92.00 | Hall/**Financial Services** |
| Celgene Corp.(CELG) | $58.10 | $26,743.4 | 1 | CELG: Looking Forward to ASCO | $74.00-$82.00 | Reames/**Health Care** |
| Isis Pharmaceuticals, Inc.(ISIS) | $9.36 | $907.9 | 1/V | ISIS: Mipomersen Data By End Of June? | $15.00-$17.00 | Reames/**Health Care** |
| Warner Chilcott Ltd.(WCRX) | $24.51 | $6,188.8 | 1/V | WCRX: 1Q Slight Beat But Revenue Missed, Raising Estimates | $28.00-$30.00 | Tong/**Health Care** |
| Leap Wireless International Inc.(LEAP) | $16.78 | $1,136.0 | 2/V | LEAP: Reports Strong Q1 Sub Growth--Lowering Estimates | $17.00-$18.00 | Fritzsche/**Media & Telecommunications** |
| MetroPCS Communications Inc.(PCS) | $8.06 | $2,874.2 | 2/V | PCS: Solid Sub Growth; But Remain Concerned LT | $8.00-$8.50 | Fritzsche/**Media & Telecommunications** |
| Brookfield Asset Management(BAM) | $24.06 | $13,930.7 | 1/V | BAM: The Playing Out Of GGP Situation Highlights Why We Like BAM | $24.00-$27.00 | Maiorana/**Real Estate, Gaming, And Lodging** |
| DCT Industrial Trust Inc.(DCT) | $5.20 | $1,234.9 | 3/V | DCT: Q1 Results Below Expectations--Maintains Guidance | $4.00-$4.50 | Maiorana/**Real Estate, Gaming, And Lodging** |
| Pebblebrook Hotel Trust(PEB) | $18.67 | $378.3 | 1/V | PEB: Will Have $320MM Post Acquisition, Lowering Ests. | $20.00-$23.00 | Donnelly/**Real Estate, Gaming, And Lodging** |
| CGI Group, Inc.(GIB) | $14.32 | $4,184.3 | 1/V | GIB: Announces Acquisition of Stanley (SXE) | $17.00-$18.00 | Boyer/**Technology & Services** |
| ExlService Holdings, Inc.(EXLS) | $16.11 | $468.8 | 2/V | EXLS: Surprise 2011 Guidance Better Than Expected; Raising Ests | $18.00-$19.00 | Caso/**Technology & Services** |
| SRA International, Inc.(SRX) | $21.21 | $1,204.7 | 2/V | SRX: FQ3 Essentially In-Line; Little Change To The Story/Issues | $19.00-$21.00 | Caso/**Technology & Services** |
| Verisk Analytics, Inc.(VRSK) | $28.00 | $5,306.0 | 2/V | VRSK: Q1'10 EPS Ahead On Strong Decision Analytics | $30.00-$32.00 | Willi/**Technology & Services** |

## Sector Overviews

| Sector | Subject Companies | Title | Analyst |
|---|---|---|---|
| Master Limited Partnerships | | MLPs: Thoughts On The Sell-Off | Blum |
| Pharmaceuticals | Impax Laboratories, Inc.(IPXL)<br>Mylan Inc.(MYL)<br>Teva Pharmaceutical Industries Ltd.(TEVA)<br>Watson Pharmaceuticals, Inc.(WPI)<br>Cumberland Pharmaceuticals, Inc.(CPIX)<br>Endo Pharmaceuticals Holdings Inc.(ENDP)<br>King Pharmaceuticals, Inc.(KG)<br>MannKind Corporation(MNKD)<br>Medicis Pharmaceutical Corporation(MRX)<br>Pozen Inc.(POZN)<br>Salix Pharmaceuticals, Ltd.(SLXP)<br>Valeant Pharmaceuticals International(VRX)<br>VIVUS, Inc.(VVUS)<br>Warner Chilcott Ltd.(WCRX)<br>Bristol-Myers Squibb Co.(BMY)<br>Eli Lilly & Company(LLY) | This Week In Wells Fargo Securities Pharma | Tong |
| Media & Entertainment | | Janedis' Online Recruitment Update | Janedis |
| Communication Technology | | Data Networking Weekly Preview | Lubert |
| Information Technology (IT) Services | Accenture plc(ACN)<br>CGI Group, Inc.(GIB)<br>Computer Sciences Corporation(CSC)<br>CACI International Inc.(CACI)<br>DynCorp International, Inc.(DCP)<br>ICF International, Inc.(ICFI)<br>ManTech International Corporation(MANT)<br>NCI, Inc.(NCIT)<br>SAIC, Inc.(SAI)<br>SRA International, Inc.(SRX)<br>Stanley, Inc.(SXE) | CGI Group Acquiring Stanley For $37.50 In Cash | Caso |
| Information Technology (IT) Services | | Wells Fargo Securities' Weekly Services Monitor | Caso |
| Software | Adobe Systems Inc.(ADBE)<br>Aspen Technology, Inc.(AZPN)<br>Blackbaud, Inc.(BLKB)<br>Deltek, Inc.(PROJ)<br>Intuit Inc.(INTU)<br>Oracle Corporation(ORCL)<br>Salesforce.com, inc.(CRM)<br>SuccessFactors, Inc.(SFSF)<br>Unica Corp.(UNCA)<br>Vocus Inc.(VOCS)<br>ArcSight, Inc.(ARST)<br>McAfee, Inc.(MFE)<br>Symantec Corp.(SYMC)<br>VMware, Inc.(VMW)<br>Websense, Inc.(WBSN) | Enterprise Software Weekly | Rueppel |

# *Synopsis* - Market Close Packet

**Industry** Energy

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Aqua America(WTR) | Kalton | $17.55 | DEC. | $0.84 | $0.92 | 2 | $2,392.1 |

Last Reporting Date: 05/06/2010 After Close

*WTR: In-line Q1; Focus On Pending PA And NJ Rate Cases*

- **Summary.** Clean Q1. We believe our '10E, '11E and long-term EPS growth estimates remain accurate. Rate relief, in particular the pending PA rate case, is the primary near-term EPS growth driver. Reiterate Market Perform rating. Our positive bias towards WTR's strategy and EPS growth profile is tempered by valuation considerations. On a forward looking basis, shares trade at roughly 19x our 2011E, a modest premium to the water utility 2010 P/E median.
- **Q1 Ongoing EPS of $0.15** (ex $0.01 investment sale gain), in-line with expectations, vs $0.14 last year. Clean Q1 overall with mgmt indicating organic customer growth is beginning to show signs of life, consistent with an improving economy. WTR's efficiency ratio registered a 130 bps improvement over 1Q09.
- **2010 Outlook.** In March, mgmt outlined expectations for 5-7% 1H net income growth accelerating to 7-10% during 2H10. We believe lower than anticipated O&M expense growth led to the 10% growth in ongoing Q1 net income which modestly outpaced mgmt's forecast. Given Q1 is a low usage period that accounts for 15-20% of EPS, we are not adjusting our annual expectations but will continue to monitor the trend. Once the sizeable backlog of rate relief works it way through the income statement over the next 12-18 months and the earned ROEs in currently depressed states improve, we believe WTR's annual EPS growth rate may revert to a more realistic, low-risk regulated rate of 5-7%.
- **EPS Estimates Unchanged.** Our '10E and '11E EPS remain $0.84 and $0.92. Drivers include the usual suspects - rate relief, O&M expense control and M&A growth - as mgmt adheres to its proven strategy. $12.2 mm in rate relief received thus far in '10 and WTR has $65 mm of rate requests pending in 9 states (bulk is PA and NJ) with plans to file an additional $20 mm by year-end. While we do not assume a settlement agreement in the pending $43.2 mm PA rate case, we believe one may be plausible (mgmt made optimistic comments regarding the prospect for both PA and NJ) which could prove our '10E conservative. Also, a return to normal weather would add roughly $0.03 to '10 EPS.
- **Financial Flexibility.** WTR continues to aggressively invest in infrastructure rehabilitation projects utilizing its strong balance sheet and cash flows. We forecast operating cash flow will fund ~85% of 2010's $300 mm CapEx budget. The balance will be achieved through debt and equity (our model reflects ~$30 mm of new equity in 2010) in order to maintain a roughly 45% consolidated equity structure. WTR's strong capital position provides financial flexibility should a significant M&A opportunity arise.

*Valuation Range Basis & Risks*

Our VR is based on a relative P/E multiple (applying a ~5% premium to the '10 group median of 18.5X to our '11E EPS) and DDM analyses. Risks include regulatory risk, potential undertaking of dilutive growth ventures and deterioration in the water industry's premium multiple relative to electric utilities.

**Industry** Energy

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Devon Energy Corporation(DVN) | Tameron | $65.34 | DEC. | $6.31 | $7.36 | 1/V | $29,272.3 |

Last Reporting Date: 05/05/2010 Before Open

*DVN: Raising Estimates For 10-Q*

- Raising Estimates. We are updating our estimates as a result of 1Q 2010 results and the filing of the 1Q 2010 10-Q. For 2010, our EPS estimate is $6.31, up from $5.92 previously. For 2011, our EPS estimate is $7.36 up from $7.31 previously.

*Valuation Range Basis & Risks*

Our valuation range is based on our NAV estimate, which includes value for both proven and unproven reserves, as well as other net assets and liabilities. Our NAV estimate for DVN is $84.08. Risks to our valuation range include overall volatility in commodity prices and divestiture timing and execution risk as the company seeks a new strategic direction.

WELLS FARGO SECURITIES

# *Synopsis* - Market Close Packet

**Industry** Energy

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| El Paso Pipeline Partners, L.P.(EPB) | Blum | $25.97 | DEC. | $2.19 | $2.19 | 2/V | $3,511.1 |

Last Reporting Date: 05/06/2010 Before Open

*EPB: Q1 Results Beat Estimates--Raising Estimates/Valuation*

- **Key Takeaways.** Q1 results beat our forecast and EPB's quarterly distribution increase was in line with expectations. We are increasing our valuation by $1 per unit to reflect a higher five-year distribution CAGR estimate of 9.4% versus 8.5% previously. We are raising our 2010 and 2011 DCF per unit estimates to $2.19, respectively, from $2.05 and $2.14 to reflect Q1 earnings and a modest increase to our base run-rate earnings estimate for Southern Natural Gas (SNG) pipeline. However, we maintain our Market Perform rating as EPB's premium valuation (yield of 5.9% versus large-cap peer group median of 7.0%) fairly reflects the partnership's steady fee-based cash flow stream, visible growth tied to organic projects and dropdowns, and strong GP sponsor support, in our view.
- **Q1 Results Beat Forecast.** Q1 adjusted EBITDA of $134.9MM beat our adjusted estimate of $114.2MM. The variance from our forecast relates primarily to higher SNG equity earnings and the noncash benefit of AFUDC, as well as lower interest expense. Q1 EPU was $0.53 versus our adjusted EPU estimate of $0.46. To note, we adjusted our Q1 estimates to make them comparable to EPB's reported results, as the partnership reported Q1 results as if they owned the recently acquired 51% ownership interest of SLNG and Elba Express for the full quarter (transaction closed on March 30, 2010).
- **DCF Exceeds Estimate--Distribution Increase In Line.** Q1 DCF per unit was $0.64 (versus our adjusted estimate of $0.55), which provided a coverage ratio of 1.6x (excess cash of $34MM). The variance from our estimate is primarily related to lower cash interest expense and the timing of maintenance capex. EPB increased its distribution by 16.9% year/year to $0.38 per unit ($1.52 annualized), which was in line with our forecast and management's guidance.

*Valuation Range Basis & Risks*

Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 11.5x our 2010 estimate. Risks to the units trading below our valuation range include a slower-than-forecasted rate of dropdown acquisitions, re-contracting, and rising interest rates.

**Industry** Energy

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Encore Energy Partners, L.P.(ENP) | Blum | $17.43 | DEC. | $2.56 | $2.57 | 1/V | $789.6 |

Last Reporting Date: 05/06/2010 Before Open

*ENP: Q1 Operating Results In Line--Raising Estimates*

- **Key Takeaways.** Q1 EBITDA was in line with our forecast; DCF beat. ENP and Denbury's (DNR) earnings conference call served to reinforce our recent upgrade and investment thesis for the MLP, following DNR's announcement late last week that it is reviewing strategic alternatives for ENP (i.e. sale, merger, or other transaction). Management indicated that it would act in the interest of ENP unitholders and is unlikely to execute on a transaction that results in cash flow or net asset value dilution to ENP unitholders. Separately, Legacy Reserves (LGCY) noted on its earnings call that ENP was a great fit for LGCY, confirming our view that ENP is likely to receive multiple bids given its highly desirable, MLP-appropriate asset base. We are raising our 2010 DCF per unit estimate to $2.56 from $2.53 primarily to reflect the Q1 variance. We are maintaining our Outperform rating as we view ENP's 11.5% yield as secure based on our price deck with upside tied to a sale of the partnership.
- **Q1 Operating Results In Line With Forecast--DCF Slightly Higher.** Q1 adjusted EBITDA of $31.8MM was in line with our estimate of $30.6MM as higher realized sales prices offset higher lease operating expenses. Adjusted EPU of $0.29 was also in line with our estimate of $0.27 and consensus of $0.28. Q1 adjusted EBITDA of $31.8MM was in line with our estimate of $30.6MM. DCF per unit of $0.61 was slightly ahead of our estimate of $0.57 primarily due to lower maintenance capex.
- **Variable Distribution Policy Maintained.** ENP declared a Q1 2010 distribution of $0.50 ($2.00 annualized), which was ahead of our forecast of $0.475 ($1.90 annualized) and represents a 7.0% sequential decrease from $0.5375 in Q4 2009. As a reminder, ENP is unique among upstream MLPs, as it employs a variable rate distribution policy whereby the partnership pays a minimum annual distribution of $1.73 and then (1) distributes 50% of excess cash flow above this level and a minimum 1.1x coverage ratio to unitholders and (2) retains the remaining 50% of excess cash flow to pay down debt. Based on the aforementioned distribution formula and our crude oil price deck (about $83/bbl over the balance of the year), we estimate ENP will maintain its current distribution of $0.50 per unit over the balance of the year. Importantly, Denbury management indicated that it intends to continue the distribution policy in accord with the prior ENP management.

*Valuation Range Basis & Risks*

Our valuation range is based on a blend of (1) our three-stage discounted free-cash flow model, which assumes a 11% required rate of return and a long-term growth rate of 0%, and (2) a price-to-distributable cash flow multiple of about 8.5x our 2010 estimate. Risks to the units trading below our range include a dependence on acquisitions to fuel growth and partially offset the depletion of reserves, the inability to hedge at favorable prices, and rising interest rates.

# *Synopsis* - Market Close Packet

**Industry** Energy

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Energy Transfer Partners, L.P.(ETP) | Blum | $45.10 | DEC. | $3.59 | $4.01 | 1 | $8,528.4 |

Last Reporting Date: 05/06/2010 Before Open

*ETP: Q1 DCF In Line With Forecast--Lowering Estimates*

- **Key Takeaways.** Q1 EBITDA was slightly below our forecast, but DCF was in line. Intrastate volumes increased 6% sequentially due to increased drilling in the Barnett Shale and Bossier Sands. While volumes have subsequently flattened, management is cautiously optimistic that volumes could increase over the course of the year, assuming natural gas prices remain above $3.50 per MMBtu. ETP provided additional transparency around its intrastate pipeline business in its earnings release. We are lowering our 2010 and 2011 DCF per unit estimates to $3.59 and $4.01, respectively, from $3.90 and $4.41 primarily to reflect a recalibration of our margin estimates based on management's additional disclosures. We maintain our Outperform rating. Our long-term distribution growth outlook for ETP remains essentially unchanged. Meanwhile, investors are paid to wait with ETP providing what we see as a secure and robust yield of 8.3%. We anticipate ETP will resume distribution growth in Q1 2011 and increase its distribution by 3-5% annually thereafter supported by improving gas fundamentals and a ramp-up of fee-based cash flow from new growth initiatives.
- **Q1 EBITDA Slightly Below Forecast.** ETP reported Q1 adjusted EBITDA of $454MM, which was below our estimate of $516MM primarily due to higher than forecast noncash losses tied to commodity derivative positions and storage contracts. After adjusting for the aforementioned noncash derivative items, Q1 EBITDA of $506MM was slightly (4.6%) below our estimate of $530MM and compares to consensus of $490MM. The shortfall was primarily due to lower propane results, which more than offset the impact of higher intrastate pipeline results. Intrastate pipeline margin benefited from a larger-than-forecast realized gain on natural gas sold from ETP's Bammel facility.
- **DCF Per Unit In Line.** Q1 2010 DCF per unit of $1.44, which excludes the aforementioned noncash items, was essentially in line with our estimate of $1.49. ETP maintained its quarterly distribution of $0.89375 per unit, which was in line with our expectation. On a TTM basis, ETP generated a coverage ratio of 0.94x (or a slight cash flow deficit of $61MM). We believe it is important to view ETP's coverage on a TTM basis given the high degree of seasonality in propane.

*Valuation Range Basis & Risks*

Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 14.5x our 2010 estimate. Risks to ETP achieving our valuation range include: (1) execution risk related to integrating acquisitions and completing organic growth projects; (2) negative outcome from third-party litigation; (3) competition in the Texas-Louisiana natural gas market; and (4) abnormally warm weather.

**Industry** Energy

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Exterran Partners, L.P.(EXLP) | Lui | $22.44 | DEC. | $2.30 | $2.80 | 1/V | $428.6 |

Last Reporting Date: 05/06/2010 Before Open

*EXLP: Q1 In Line With Full-Quarter Benefit From Dropdown*

- **Key Takeaways**. Q1 adjusted EBITDA was essentially in line with our forecast, but DCF was above expectations due to timing of maintenance capex. We are maintaining our 2010 and 2011 DCF per unit estimates of $2.30 and $2.80, respectively. Despite headwinds from a low natural gas price environment on domestic demand for contract compression, EXLP's distribution remains secure, in our view. Q1 coverage was 1.2x and the GP remains supportive via potential dropdowns and cost cap adjustments, which help strengthen the partnership's cash flow. With an attractive yield of 8.2% (versus 8.1% for small-cap pipeline MLPs), risk/reward for EXLP remains compelling, in our view.
- **Operating Results Essentially In Line.** Q1 adjusted EBITDA was $22.4MM versus our estimate of $23.4MM. EPU of $0.05 was slightly below our forecast of $0.08 primarily due to higher-than-anticipated DD&A expense. Q1 results reflect a full-quarter benefit from the $143MM acquisition of 270,000 horsepower (hp) from the partnership's GP sponsor (EXH), completed in November 2009. The benefit from (1) higher-than-expected hp utilization (81% versus our estimate of 78% and 79% in Q4 2009) and (2) slightly lower-than-anticipated SG&A expense of approximately $1MM was more than offset by the impact of a lower adjusted gross margin (i.e. 56% versus our forecast of 58%). Excluding the operating cost cap of $2.8MM, gross margin was 51%.
- **DCF Higher On Capex Timing But Distribution In Line.** Q1 DCF per unit of $0.58 was ahead of our forecast of $0.48 primarily due to lower-than-expected maintenance capex (i.e. $2MM versus our estimate $5MM). As anticipated, EXLP maintained its quarterly distribution of $0.4625 (or $1.85 annualized). Q1 distribution coverage was solid at 1.2x (or excess cash flow of $3MM).

*Valuation Range Basis & Risks*

Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 9.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 11x our 2010 estimate. Risks to the units trading below our valuation range include dependence on acquisitions to fuel growth, customer concentration, and rising interest rates.

WELLS FARGO SECURITIES

# *Synopsis* - Market Close Packet

**Industry** Energy

| | Analyst |
|---|---|
| Master Limited Partnerships | Blum |

*MLPs: Thoughts On The Sell-Off*

- **Correction Driven By Broader Market Factors.** Since 5/3/10, the Wells Fargo Securities MLP Index is off 10% (as of 5/6/10) compared to 6% for the S&P 500. Many sector specific reasons have been thrown about to explain the pullback. However, we believe weakness is being driven by broader market issues including: (1) overall market weakness, (2) widening credit spreads due to contagion fears around Greece, and (3) a decrease in crude oil prices. Lastly, (as we pointed our in our May Monthly) MLPs were poised for some price rationalization, having reached fair value from a valuation standpoint after a torrid run.
- **MLP Specific Factors Driving Weakness.** To review, the weakness in MLPs is likely due to a combination of the following factors. (1) A large indiscriminate seller was in the market on 5/5/10, (2) many MLPs traded ex-dividend on 5/5/10, which oftentimes creates selling pressure, (3) crude oil prices decreased, pulling the energy tape lower, (4) sector weakness may have triggered stop loss selling among some investors, which begets more selling, and (5) credit spreads widened, which is a key driver of MLP performance.
- **Weakness Highlights Risks In MLP Investing.** The selloff highlights some of the risks and drivers in MLPs including the sector's relative illiquidity which exaggerates price movements in both directions, in our view. We would remind investors that MLP correlations to the overall stock market (0.95 to the S&P500), crude oil prices (correlation of 0.85), and high yield credit spreads (0.86) have been meaningful over the last year. To the extent that the overall market continues to be volatile, crude oil prices continue to retreat and the credit market rally is over and reversing, MLPs could experience further headwinds.
- **A Buying Opportunity MLP Fundamentals Are Solid - Focus On Quality.** We view this correction as an opportunity to build positions in high quality names. To the extent new entrants to the sector were reluctant to invest given the strong run up in prices, this pullback creates an attractive entry point, in our view. Notably, in spite of the macro headwinds, MLP fundamentals remain solid as evidenced by the strong earnings season to date (10 out 15 in-line or above forecast and median year/year distribution growth of 3.1%).
- **What Looks Especially Attractive?** In addition to our top picks of EPD ($32.62), ETE ($31.72), GEL ($17.89), SPH (44.21), SXL ($63.19) (see MLP Monthly dated 5/6/10), we would highlight ENP ($17.59), MMP ($43.92), OKS ($57.43), PAA ($53.99), RGNC ($20.99), and NGLS ($24.68).

**Industry** Energy

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Westar Energy, Inc.(WR) | Kalton | $22.16 | DEC. | $1.75 | $1.70 | 1 | $2,446.5 |

Last Reporting Date: 05/06/2010 After Close

*WR: Bests Q1 Expectations On Strong Sales Growth*

- **Summary.** WR reported Q1 results of $0.27, above our estimate of $0.24 and consensus of $0.18. Strong results were driven by a 6.8% increase in retail sales (favorable weather and strong underlying growth). Management reiterated 2010 EPS guidance of $1.65-1.80 and we are maintaining our 10-12E EPS of $1.75, $1.70 and $2.15. We reiterate our Outperform rating and $24-25 valuation range.
- **Sales Impress.** While weather was a benefit (heating degree days 10% above normal), it appears that strong underlying sales growth, including a 6.2% rise in economically sensitive industrial sales, drove roughly 4% of the 6.8% retail sales growth. This compares with WR's full-year assumption of 2% weather-adjusted retail sales growth. Kansas' economy continues to outperform the national economy (6.5% unemployment) and management noted strength in the oil and gas and food/pet food industries; aircraft manufacturers continue to lag.
- **EPS Outlook.** WR reiterated 2010 EPS guidance of $1.65-1.80. We are maintaining our 2010E EPS of $1.75 despite a better-than-expected Q1. Should weather-adjusted sales growth continue to trend above plan we believe there is upside to our estimate. That said, our estimate assumes $11MM of COLI proceeds, none of which have been realized in Q1. We are also maintaining our 2011E and 2012E of $1.70 and $2.15. See Figure 1 for the key assumptions underlying our 2010-13 EPS estimates.
- **Rate Case/Equity Comments.** Management noted that favorable sales and cost trends could allow WR to defer a general rate case filing. We continue to assume an early 2011 filing with new rates effective early 2012. Rate case timing likely also impacts the timing of equity needs as we believe the company has 3-4 months after filing a rate case to have that equity incorporated in the case, aimed to achieve at least a 50% equity ratio. We believe WR will likely use a mixture of its three-year $500MM dribble program and a secondary offering to meet equity needs. Our model assumes $375MM of equity issued in mid-2011.
- **Reiterate Outperform.** Favorable attributes, in our view, include a sound regulatory environment, including rider mechanisms for transmission and environmental investment, a strong management team, and attractive valuation (7% discount to peers on 2012 EPS). Shares offer a 5.6% yield on the common dividend, which we consider to be secure with modest growth potential.

*Valuation Range Basis & Risks*

Our valuation range is based on a P/E multiple (apply an 11-11.5X multiple to our 12E EPS of $2.15), residual income and dividend discount analyses. Risks to our valuation include adverse regulatory developments and the impact of a continued economic downturn.

# *Synopsis* - Market Close Packet

**Industry** Energy

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Western Gas Partners, L.P.(WES) | Lui | $22.05 | DEC. | $1.85 | $1.84 | 2/V | $1,400.2 |

Last Reporting Date: 05/05/2010 After Close

*WES: Q1 2010 Results Slightly Above Forecast--Raising Estimates*

- **Key Takeaways.** Q1 results exceeded our forecast on higher product margin. WES increased its distribution 3% sequentially, which was essentially in line with our forecast. We are increasing our 2010 DCF per unit estimate to $1.85 from $1.82 to reflect Q1 results. Management reiterated its 2010 EBITDA guidance of $130-150MM, which is in line with our current and prior forecast. Although management indicated that it is focused on potential dropdowns from Anadarko (the GP sponsor), WES also continues to evaluate third-party acquisition opportunities. We maintain our Market Perform rating, as WES's growth prospects appear fairly reflected in the current valuation, in our view.
- **Q1 Results Slightly Ahead Of Forecast.** Q1 adjusted EBITDA was $36.5MM versus our estimate of $33.9MM. The variance from our estimate is primarily due to stronger-than-anticipated contributions from the sale of condensate. The benefit more than offset lower total throughput attributable to WES of 1.375 Bcf/d versus our estimate of 1.401 Bcf/d. Q1 EPU was $0.37 versus our estimate of $0.35, consensus of $0.33, and $0.30 a year ago.
- **Quarterly DCF Beats--Distribution Essentially In Line.** Q1 DCF per unit of $0.52 exceeded our estimate of $0.45 and provided distribution coverage of 1.5x (excess cash flow of about $11MM). The positive variance was attributable to Q1 earnings and the timing of maintenance capex. WES increased its quarterly distribution 3% sequentially to $0.34 per unit ($1.36 per unit), which was essentially in line with our estimate of $0.3375 per unit). Based on the Q1 declared distribution, we are increasing our 2010 distribution growth estimate to 10.9% from 10.1%.

*Valuation Range Basis & Risks*

Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 9.0% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 11.5x our 2010 estimate. Risks to the units trading below our valuation range include a slower than forecast rate of dropdowns, customer concentration, and rising interest rates.

**Industry** Financial Services

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| PartnerRe Ltd.(PRE) | Hall | $73.18 | DEC. | $6.40 | $10.20 | 1 | $6,044.7 |

Last Reporting Date: 05/06/2010 After Close

*PRE: Conference Call Round-Up*

- **SUMMARY:** PartnerRe hosted its Q1 2009 earnings conference call today. Key issues addressed included market conditions, PARIS RE integration and details on the Deepwater Horizon rig loss. We are adjusting our 2010 and 2011 EPS estimates to $6.40 and $10.20 (from $6.87 and $10.30, respectively) to reflect higher interest expense and rig losses, partially offset by higher share repurchase. The PRE shares should be largely unchanged following the call.
- PRE described the current market environment as acceptable, although not great. Management does not see a near-term catalyst in either the reinsurance or capital markets that would improve trends. Overall, PRE expects the reinsurance industry's profitability levels to remain in the high single digits.
- Management did point to some select pockets of opportunity. In its non-life book, PRE could benefit from higher rates in Latin American, mainly on facultative business and in energy and marine lines, following the recent losses.
- PRE expects its life business to become a bigger contributor to premiums over the next few years. The company is seeing more longevity reinsurance deals, particularly in the UK and increased demand on the mortality side from European life insurers seeking capital relief prior to Solvency II.
- As it had expected PRE saw about a 20% reduction in PARIS RE premiums during both the January and April 1 renewals (after adjusting for the business that moved over to PartnerRe paper). About half the decline was due to client preference and the other half to PRE's decision to nonrenew.
- Last week, PRE provided an initial estimate for the Deepwater Horizon rig loss of $60-70MM pre-tax (or $0.64-0.75/sh after tax) based on a $1B loss estimate.
- Despite new reports of an industry loss estimate as high as $3.5 billion, PRE sees no reason to revise its own loss estimates. Two thirds of its exposure is capped by retro coverage. In a 'worst case' PRE could see additional $10-20 million of losses for its PARIS RE treaty book, which is not covered by retro.
- Mr. Thiele commented on his pending retirement. He noted the announcement was not a surprise to the Board, just a normal transition following his ten years as CEO, and that a succession plan has been in place for three years.
- PRE has no exposure to the sovereign debt of the PIIGS (Portugal, Ireland, Italy, Greece, and Spain) countries. All remaining holdings of this type of government bond were sold in mid January.

*Valuation Range Basis & Risks*

Our valuation range of $86-92 is based on a 0.95-1.05x multiple of our projected 2010 book value. Risks to achieving our valuation range include large catastrophe losses, increased competition, a deterioration in loss costs, and a rise in D&O claims.

**Industry** Health Care

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Celgene Corp.(CELG) | Reames | $58.10 | DEC. | $2.66 | $3.49 | 1 | $26,743.4 |

Last Reporting Date: 04/29/2010 Before Open

*CELG: Looking Forward to ASCO*

- **Summary.** Celgene's outstanding "beat and raise" quarter was driven predominately by Revlimid which despite reaching a $2+ billion annual run rate, grew an impressive 46% year-over-year. Global expansion, share gains in earlier lines of therapy across major markets, and increasing treatment duration remain in the near-term growth engines. We now turn to the American Society of Clinical Oncology (ASCO) June 4-8, where important new data is to be presented that has the potential to support future growth. Overall, we look forward to seeing over 50 abstracts and more than 10 oral presentations. Abstract titles have already been posted with the full content posted on May 20 at 6 p.m. EST. At this venue, definitive evidence from prospective randomized trials emerge in the field of myeloma that should change prescribing habits. KOLs have noted that following the presentation of CALGB 100104 and IFM-2005-02 it will be unethical to not prescribe Revlimid in the maintenance setting. We still believe the financial impact of continuous dosing is underappreciated; indeed it should help drive hematology-oncology total revenues to $6 billion in 2015. Behind this we expect to Revlimid + Rituxan in lymphoma to continue to impress.
- **Maintenance Expectations**. For us, the more interesting maintenance data set is from IFM 2005-02 because it is more robust (longer follow-up, more patients) and it answers key questions about the impact of maintenance following consolidation (which could have negated the benefit of Rev maintenance). During recent conversations with consultants who have intimate knowledge of the maintenance studies, it was underscored that the results from the CALGB and IFM trials are very concordant. We expect an impressive ~60% delay in in the risk of tumor progression for Revlimid and 2-yr survival of ~95%.
- Keen Interest in Lymphoma. Beyond myeloma, our attention remains on data that will have the greatest implications for future long-term growth, namely results from studies in NHL. Although there are 180k myeloma patients eligible for Revlimid in the U.S., E.U.-5 and Japan, there are 225k eligible follicular lymphoma patients and 260k eligible diffuse B-cell lymphoma patients. Updated results from Fowler evaluating the combination of Revlimid and Rituxan are expected to build on the impressive results presented at ASH 2009.
- Elimination of Transplant? At ASCO 2010, updated results from a trial comparing an all oral regimen to high-intensity transplant are to be presented. Recall, at ASH 2009, a similar PFS emerged from this presentation.
- **Other Noteworthy Data Sets.** Amrubicin in lung cancer, Istodax in lymphoma and Revlimid in prostate cancer and CLL

*Valuation Range Basis & Risks*

We value Celgene by applying a 28-34x P/E multiple to our 2011 EPS estimate of $3.49, discounted 15-20%, to arrive at a valuation range of $74.00-82.00. Celgene faces a Teva thalidomide ANDA challenge and Revlimid competitive pressures.

**Industry** Health Care

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Isis Pharmaceuticals, Inc.(ISIS) | Reames | $9.36 | DEC. | ($0.43) | ($0.01) | 1/V | $907.9 |

Last Reporting Date: 05/06/2010 Before Open

*ISIS: Mipomersen Data By End Of June?*

- **Summary.** Yesterday (5/6), investors received an update on mipomersen from both the Isis Q1 call and Genzyme's analyst day. At the May 6, 2010, Genzyme analyst day, mipomersen was highlighted as one of three key late-stage pipeline products and we highlight portions of this presentation below. Mid-2010 should be a pivotal period in Isis' history as it completes three key studies for mipomersen. Cash and equivalents as of March 31, 2010, were $519 million.
- **Mipomersen, "A Transforming Product."** It was clear that Genzyme has no plans for returning the rights to mipomersen to Isis. To the contrary, Genzyme has created the new Personalized Genetic Health business unit, which will include cardiovascular products (*Cholestagel* and mipomersen). The unit is to be overseen by John Butler, SVP, who was instrumental in helping grow the renal franchise. Mr. Butler's prior experience as VP of *Renagel* Europe should be critical in a strong initial EU launch in late 2011/early 2012 as there are roughly 15,000+severe and 25,000 HeFH patients in Europe. Although *Cholestagel* is not a key product for Genzyme in Europe, marketing the product has provided invaluable experience in building EU KOL and lipidologist relationships and in negotiating drug pricing in the cholesterol market. Genzyme has met with the EMeA, reviewed Phase II and III data, engaged in the EMeA's formal Scientific Advice Process, and expects initial feedback during the summer. In the meantime, Phase III data from the 301012-CS12 study in high-risk hypercholesterolemia and MIPO3500108 study in severe hypercholesterolemia not on apheresis are due in late June/early July. These data would round out the MAA and NDA packages, which are to be submitted in H1 2011. The Phase I subcutaneous MIPO3200309 study evaluating 30mg daily, 70mg thrice weekly, and 200mg once weekly (for three weeks) are expected in early Q3. More-frequent dosing may provide for improved tolerability and ultimately fewer patients discontinuing therapy. These data would be used to help design the outcomes study required to support approval in HeFH (U.S.) and the larger polygenic populations (U.S. and EU). In addition, upon confirmation in a larger efficacy study, Genzyme plans on seeking inclusion of the 30mg and 70mg dose data in the approved labels. Finally, Mr. Butler noted that in the HeFH patients who experienced increases in ALT levels above 3x the upper limits of normal, that the median LCL-c reduction was 44%, higher than the 33% mean placebo-adjusted reduction in the ITT group. This apparent pharmacologic effect may help stem investor concerns over the transient ALT elevations.

*Valuation Range Basis & Risks*

We value Isis based on a sum-of-the-parts analysis using our 2013 revenue estimate of $247 million, capitalized 6-7x, and discounted at 20%; combined with an estimated YE:2010 cash position of $420 million and pipeline/IP estate value of $400-500 million to arrive at a 2010 value of $1.8-2.0 billion. With 116 million shares outstanding, we arrive at a valuation range of $15.00-17.00. Risks include failure of clinical trials and changes in mipomersen regulatory requirements.

# *Synopsis* - Market Close Packet

**Industry** Health Care

Pharmaceuticals

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Impax Laboratories, Inc.(IPXL) | Tong | $17.32 | DEC. | $2.84 | $1.25 | 1/V | $1,060.0 |
| Mylan Inc.(MYL) | Tong | $21.50 | DEC. | $1.61 | $1.89 | 2/V | $6,546.8 |
| Teva Pharmaceutical Industries Ltd.(TEVA) | Tong | $57.53 | DEC. | $4.56 | $5.39 | 1 | $51,431.8 |
| Watson Pharmaceuticals, Inc.(WPI) | Tong | $42.31 | DEC. | $3.36 | $3.80 | 1 | $5,026.4 |
| Cumberland Pharmaceuticals, Inc.(CPIX) | Tong | $10.05 | DEC. | $0.44 | $1.64 | 1/V | $221.1 |
| Endo Pharmaceuticals Holdings Inc.(ENDP) | Tong | $21.31 | DEC. | $3.16 | $3.20 | 2 | $2,506.1 |
| King Pharmaceuticals, Inc.(KG) | Tong | $9.82 | DEC. | $0.82 | $0.86 | 1/V | $2,454.0 |
| MannKind Corporation(MNKD) | Tong | $6.25 | DEC. | $0.00 | ($1.01) | 1/V | $706.3 |
| Medicis Pharmaceutical Corporation(MRX) | Tong | $23.50 | DEC. | $2.05 | $2.33 | 1/V | $1,348.9 |
| Pozen Inc.(POZN) | Tong | $8.44 | DEC. | $0.02 | $0.48 | 2/V | $251.5 |
| Salix Pharmaceuticals, Ltd.(SLXP) | Tong | $36.94 | DEC. | ($0.24) | $1.45 | 2/V | $1,928.3 |
| Valeant Pharmaceuticals International(VRX) | Tong | $45.41 | DEC. | $2.61 | $3.06 | 3/V | $3,755.4 |
| VIVUS, Inc.(VVUS) | Tong | $11.08 | DEC. | ($0.94) | ($0.16) | 2/V | $893.0 |
| Warner Chilcott Ltd.(WCRX) | Tong | $24.51 | DEC. | $3.34 | $3.70 | 1/V | $6,188.8 |
| Bristol-Myers Squibb Co.(BMY) | Tong | $24.48 | DEC. | $2.12 | $2.25 | 1 | $42,228.0 |
| Eli Lilly & Company(LLY) | Tong | $34.56 | DEC. | $4.46 | $4.61 | 2 | $38,133.5 |

*This Week In Wells Fargo Securities Pharma*

- **For the week ending mid-day May 7, the Generic Drug group fell 2.4% while the Specialty group fell 6.0%.** These compare to a 6.9% fall in the NASDAQ Composite Index and a 5.5% decrease for the S&P 500 Index.
- **Earnings Recap:** IPXL: 1Q Beat Driven By Generic Flomax, Further Upside Likely; KG: 1Q Missed Expectations, Long-term Thesis Intact; MRX: Strong 1Q, Guidance and Estimates Raised; Well-Positioned for Growth; TEVA: Solid 1Q 2010; VRX: 1Q Beat On R&D; VVUS: 1Q In-line - Next Major Catalyst In 3Q; WCRX: 1Q Slight Beat, Rev Missed - Maintain Outperform--But Will Need Patience.
- **BMY: Belatacept Received CRL With Minor Issues -- Lowered Estimates** - We now expect mid-2011 approval.
- **LLY: Exenatide Once-Weekly (Bydureon) Receives New Timeline** - Class 2 resubmission; New PDUFA date is set for October 22, 2010.
- **POZN: Vimovo Approval Long-Term Positive -- Lowered Near-Term Estimates** - Believe NT share price movement may be restrained.
- **SLXP: Presented Additional Xifaxan Phase III Data** - SLXP expects to submit the NDA for Xifaxan 550mg in non-C IBS (or IBS-D) before the end of 2Q.
- **WPI: Confirmed Evista Patent Challenge** - Annual sales of Evista are ~$690MM.
- **Earnings Report Next Week: 5/10 - WPI, SLXP; 5/13 - CPIX**

**Industry** Health Care

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Warner Chilcott Ltd.(WCRX) | Tong | $24.51 | DEC. | $3.32 | | 1/V | $6,188.8 |

Last Reporting Date: 05/07/2010 Before Open

*WCRX: 1Q Slight Beat But Revenue Missed, Raising Estimates*

- **Summary.** Maintain Outperform rating on WCRX. Valuation appears attractive at 7.3x our 2010 cash EPS estimate. Raised 2010E cash EPS to $3.34 from $3.32. Introducing 2011E cash EPS of $3.70. Management reiterated 2010 EPS guidance of $3.30 - $3.40. Lowering valuation range to $28 - $30 (8.5-9x 2010 cash EPS) from $30-33. While shares are attractively valued, execution risks remain and the 1Q 2010 revenue miss suggests WCRX may take a while to regain investor confidence.
- **Maintain Outperform.** While we believe the near-term could be choppy, we continue to maintain our Outperform rating on WCRX. Our rating is based on our belief that a re-configured sales force could curb the slide in Actonel prescriptions, the Asacol franchise will continue to successfully transition to the HD formulation, and attractive valuation (7.3x our 2010 cash EPS estimate of $3.34, vs. peer group of 12-13x).
- **We are raising our 2010 cash EPS estimate to $3.34 from $3.32.** The change primarily reflects a higher gross margin (lower COGS), partially offset by higher SG&A expenses. We are also introducing our 2011 cash EPS estimate of $3.70. Management reiterated 2010 EPS guidance of $3.30 - $3.40, while changing several other metrics. Please see Exhibit 2 for more details.
- **Key takeaways:** 1) Actonel TRx in the US declined 21.6% yoy. However, the decline appears to be decelerating (-24.2% in 2009). The PDUFA date for next-generation Actonel is July 2010; 2) Asacol transition to the HD formulation (800mg) remains a work-in-progress with encouraging recent TRx trends; and 3) Doryx the 150mg strength represented over 90% of franchise prescriptions. Reported revenue was below Rx demand trend due to contraction of trade inventory level.
- **WCRX reported adjusted 1Q EPS of $0.88 on revenue of $688.6MM.** This compares to our estimates of $0.96 and $739.9MM. Consensus estimates were $0.86 and $764.8MM. The revenue miss was driven by lower than expected results for Actonel (the international segment; $108.5MM A vs. our $132.2MM E), Doryx ($50.9MM A vs. our $64.2MM E), and other revenues ($43.8MM A vs. our $55.8MM E). SG&A came in ~$43MM above our $277.3MM estimate, while R&D was ~$6.8MM below our estimate.

*Valuation Range Basis & Risks*

We believe the stock could trade in the $28-30 range in the next 12 months, based on a P/E multiple of 8-9.5.x our 2010 cash EPS estimate of $3.34. Risks to the stock trading to our valuation range include the inability to integrate PGP effectively and deceleration in core product growth.

WELLS FARGO SECURITIES

# *Synopsis* - Market Close Packet

**Industry** Media & Telecommunications

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Leap Wireless International Inc.(LEAP) | Fritzsche | $16.78 | DEC. | $7.81 | $9.08 | 2/V | $1,136.0 |

Last Reporting Date: 05/06/2010 After Close

*LEAP: Reports Strong Q1 Sub Growth--Lowering Estimates*

- LEAP's Q1 results were characterized by much-better subscriber growth as it benefited from a fairly quiet prepay promotional environment and customers' higher disposable income trends. Despite this performance, we remain at a Market Perform rating on the shares. With both PCS and LEAP we have limited visibility as to the remainder of 2010 trends given the volitility in the churn and ARPU metrics. While we were encouraged that the new Sprint plans did not lower the bar for unlimited voice/text service, we still believe there will be promotion and marketing activities around new competitor price plans (at Sprint and others) that could cause LEAP to lose some of the share of gross adds. Our new 2010E revenue and EBITDA are $2.7B and $595MM from $2.76B and $607MM. Our new 2011E revenue and EBITDA are $2.92B and $698MM from $3.09B and $742 MM. Valuation range goes from $13-15 to $17-18.
- **Q1 RESULTS--**LEAP reported 446,000 net adds versus our estimate of 359,000. 249,000 came from voice and 197,000 came from broadband. Gross adds were slightly better at 1.1MM versus our 1.05MM estimate. Churn of 4.5% was better than our 4.7%. ARPU was lower at $37.96 versus our $38.41 estimate. Weaker ARPU offset the greater sub growth in terms of total revenue for Q1. Specifically, total revenue was $654MM versus our $659MM estimate, despite better sub growth. EBITDA for Q1 was $123MM including the one-time impact of $4MM charge related to store and staffing adjustments.
- **EXPECT Q2 RESULTS TO SHOW TYPICAL SEASONALITY--**While management would not give specific guidance as to Q2 expectations, we would note given that its new price plans only began on March 23, we expect the momentum coming from this promotion to have continued through most of April and early May. Offsetting this better gross add promotion is higher seasonal churn. We note churn increased 90bps between Q1 and Q2 in 2009. While we do not expect as much of an increase in 2010--directionally we do believe it will go higher in Q2 (which management also confirmed).
- **LEAP OFFERS SOME NEAR-TERM GUIDANCE--**Leap sees margin improving throughout the year as Broadband and Expansion markets improve from breakeven. Leap expects strong sequential EBITDA growth of approximately 45% in Q2 on these trends and cost management. For the full year, Leap expects to reap $175-225MM of cost and productivity benefits. However, we note all these savings will not be seen in EBITDA expansion--some is to be used to reinvest in the business and help offset continued ARPU deterioration. Leap expects continued ARPU pressure from the popularity of the Broadband and PayGo products to continue to weigh on ARPU throughout the year, but the H2 introduction of smartphones should help slow the decline.

*Valuation Range Basis & Risks*

Our range of $17-18 per share is based on 5.0-5.1x 2011E EBITDA. Risks include increasing competition, higher-than-expected capex with new markets, ARPU and churn pressure due to competition and weak economy.

**Industry** Media & Telecommunications

| | Analyst |
|---|---|
| Media & Entertainment | Janedis |

*Janedis' Online Recruitment Update*

- **Weekly look at global job postings:** This note summarizes our weekly job posting checks across markets and verticals. Postings growth for most of our samples is now in the double digits, as the employment environment appears to have stabilized. However, absolute volume of postings remains well below the levels seen in 2007-08, suggesting some lingering slack in employment. In light of lingering macro uncertainty and somewhat optimistic market expectations of a cyclical rebound, we remain cautious on both Monster (MWW, Market Perform, $16.62) and Dice (DHX, Market Perform, $8.43).
- **Monster.com postings growth off slightly versus last week:** Our sampling in top DMAs showed postings were up 18% yr/yr in the recent week (5/5) versus +19% for the previous week. Postings volume declined modestly versus last week. MTD postings are up 18% in May, versus +17% in April, +8% in March, -1% in February, and flat growth in January.
- **Dice.com postings growth remains at near 40%:** Dice.com postings were up 40% yr/yr in the recent week (5/6) versus +44% the previous week. MTD postings are up 40% in May, versus +35% in April, +14% in March, +5% in February, and -6% for January.
- **eFinancialCareers postings growth now more than 30%:** Postings growth was +32% yr/yr in the recent week (5/6), versus +28% the previous week. Key market trends include: U.S. +27% (+30% previous week), U.K. +55% (+52% previous week), France +28% (+10% previous week), and Germany off 14% (-16% previous week). MTD growth for May is 32%, versus +26% in April, +16% in March, +5% in February, and -8% in January.
- **Stepstone.com postings growth jumps to high teens:** For the recent week (5/05) postings were up 18% versus +12% in the previous week. Trends in key markets included: U.K. +12% (+1% previous week), Germany +39% (+31% previous week), and Belgium +23% (+19% previous week). May postings are up 18% MTD, versus +7% in April postings, -4% in March, -9% in February, and -17% in January.
- **Staffing firms posting growth moves higher:** Postings for our sample were up 25% yr/yr in the latest week (5/7), versus +23% the previous week. Robert Half was off 4% (+2% previous week), Manpower was +16% (+41% previous week), and Kelly was +93% (+63% previous week). MTD postings are up 25% in May versus +19% in April, +12% in March, +3% in February, and -7% in January.
- **Valuations already imply material improvement:** Monster and Dice are trading at 21.3x and 13.5x our 2010 (FY1) EV/EBITDA estimates, versus 2009 lows of about 2x and 3x, respectively. We think secular issues within online recruitment may offset the cyclical recovery that appears to be assumed by current valuation.

# *Synopsis* - Market Close Packet

**Industry** Media & Telecommunications

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| MetroPCS Communications Inc.(PCS) | Fritzsche | $8.06 | DEC. | $2.98 | $3.57 | 2/V | $2,874.2 |

Last Reporting Date: 05/06/2010 Before Open

*PCS: Solid Sub Growth; But Remain Concerned LT*

- PCS reported Q1 results. These results were characterized by extremely solid sub growth & better than expected churn. Revenues came in better, while EBITDA was lower mainly due to higher gross adds. We are adjusting our estimates to reflect stronger subscriber growth, lower ARPU and lower churn than modeled. Our new '10 revenue, EBITDA and EPS estimates are $4.0B, $1.06B and $0.44 versus our prior estimates of $4.0B, $1.14B and $0.55. Our new '11 revenue, EBITDA and EPS estimates are $4.5B, $1.3B and $0.72 versus our prior estimates of $4.4B, $1.3B and $0.72. We are raising our net add number for 2010 from 837k to 1.24MM. While PCS's Q1 results were clearly impressive and we were encouraged that the new Sprint pricing plans did not lower the bar for unlimited price points, we remain on the sidelines here as we continue to be cautious as to how the overall promotional environment in the prepay space near term could impact PCS's share of gross adds near term. We are raising our valuation range from $6.50 - $7.50 to $8.00 - $8.50. **We maintain our Market Perform (2) rating on the shares.**
- **SUBSCRIBER GROWTH SIGNIFICANTLY BETTER THAN EXPECTED; SOLID START TO 2010** - Gross adds in the quarter were 1.47M versus our estimate of 1.43M. Net adds were much better than modeled at 691k vs our estimate of 418k and street consensus of 382k. While PCS does not break out results between legacy and Northeast any more, management indicated it is still "gaining traction" in the Northeast and saw solid results in legacy.
- **NEW SPRINT PLANS MAY NOT BE AS APPEALING TO PCS USERS GIVEN MOU TRENDS** - When asked about risk from the newly introduced Sprint plans - management indicated the average minutes of use (MOU) of its base would indicate that its customer base favors the unlimited model. Put another way, the new plans outlined by Virgin Mobile / S this morning likely will not be attractive to PCS's base, in management's view, as the unlimited voice option is still $20 above PCS's $40 plan.
- **LIMITED GUIDANCE BUT DO EXPECT TYPICAL SEASONALITY OF CHURN & SUB GROWTH** - While the company did not give forward looking guidance, it did indicate it expects lower adds and higher churn in the summer months. Despite this, PCS's CEO indicated it is "pleased so far with the momentum" seen going into this time period.

*Valuation Range Basis & Risks*

Our valuation range is based on a 5.0x–5.2x 2010E EV/EBITDA multiple. Risks to our range include increasing competition from larger carriers, higher churn associated with the company's customer base, and potential market launch delays.

**Industry** Real Estate, Gaming, And Lodging

| | Analyst | Price | FY | FY09E | FY10E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Brookfield Asset Management(BAM) | Maiorana | $24.06 | DEC. | $1.48 | $1.60 | 1/V | $13,930.7 |

Last Reporting Date: 11/06/2009 Before Open

*BAM: The Playing Out Of GGP Situation Highlights Why We Like BAM*

- The Wall Street Journal reported this morning (5/7) General Growth (GGP), in a hearing scheduled with Judge Gropper later today, will seek to affirm the recapitalization proposal from the BAM-led consortium as the interim option for GGP. For details see the squawk from fellow REIT analyst Jeff Donnelly, "GGP: BAM May Have It. Pershing Square May Drop Warrants." We view the playing out of the GGP situation as a microcosm of many of the reasons we like BAM:
- **(1) BAM is disciplined with its investment strategy.** BAM has made very few adjustments to its original offer for GGP--the warrant package was tweaked a little, but essence of its bid has remained at $10 per share for GGP and $5 per share for GGO. This is consistent with BAM's deal-making strategy over the years. We feel comfortable BAM will continue to be a strong allocator of capital.
- **(2) BAM is viewed as a strong partner** for both coinvestors and investees. Track record and reputation is attracting interest from investment partners, which we believe should have positive benefits for AUM growth. BAM is often viewed favorably by companies it seeks to invest in, generally allowing BAM to win competitive bids where it's not the highest bidder. We believe this will continue to be a big plus for BAM as it ramps up investment activity.
- **(3) BAM doesn't need GGP**. BAM is seeing significant external investment opportunities. BAM noted on its conference call (5/6) that it's seeing a significant amount of opportunities, and the trouble is identifying the really great opportunities from merely great ones. This is in contrast to most of the REITs we cover that have expressed difficulty finding attractive opportunities.
- **(4) BAM doesn't need GGP**. It has significant internal growth opportunities. BAM isn't planning to monetize significant amounts of assets in the near term because it believes existing asset base has a lot of growth potential. This could be viewed as a cop-out if it weren't active on the deal front, but it is, so this position appears logical, in our view.
- Shares trade at a relative discount versus REITs. Current estimated sum-of-parts value is $24+ per share, but we believe there is significant upside potential over the next few years--AUM growth could generate $8+ per share of incremental value ($5+ per share of NPV), and there is significant potential upside in power operations. Overall, investment in GGP may not be material to total value of BAM, but its actions--whether or not it wins or loses GGP--highlight why BAM is a good investment, in our view.

*Valuation Range Basis & Risks*

Low-end based on NAVe mid-pt; high-end = 10% premium. Risks: Organizational complexity and investments in public companies could lead to conflicts of interests upon divestitures and investments; significant income in recent years has been derived from monetization and trading gains, which could be reduced.

WELLS FARGO SECURITIES

# *Synopsis* - Market Close Packet

**Industry** Real Estate, Gaming, And Lodging

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| DCT Industrial Trust Inc.(DCT) | Maiorana | $5.20 | DEC. | $0.42 | $0.41 | 3/V | $1,234.9 |

Last Reporting Date: 05/06/2010 After Close

*DCT: Q1 Results Below Expectations--Maintains Guidance*

- **Summary:** DCT reported Q1 2010 FFO of $0.10 per share, $0.01 below our estimate and consensus. Rents were in line, but higher operating expenses and a $1.0MM (<$0.005 per share) caused the miss. FAD (FFO less capex and straight-line rent) was $0.08 per share, which was in line with our estimate despite lower FFO owing to lower than expected capex costs. We plan to revisit our estimates and valuation range after the conference call today (5/7).
- **Leasing/Operations:** Occupancy declined 230bps to 85.3%. A sizable drop in Q1 was expected, but the range previously discussed by management was 100-200bps. Leasing volume was decent however (3.2MMsq.ft.), particularly for Q1, which tends to be seasonally slow. Releasing spreads remained weak at -8.8% cash. The renewal rate of 65% was down from recent trend. Same-store NOI was -13.7% cash, dropping from -8.3% in Q4. We look for same-store to improve during the year as occupancy steadies. Capex costs were steady at $0.36/sq.ft./ yr, consistent with recent results. The leased rate on the development pipeline improved from 21% to 34%--now at the top-end of the year guidance of 30-35%. Projected yields on the pipeline declined 10bps to 5.9%.
- **Investment Activity:** DCT previously anounced the implementation of a 20MM share continuous equity offering program (about $100MM at current share price) of which $9MM was raised to date. Proceeds were used to acquire a 150,000sq.ft. bulk distribution asset in New Jersey for $9.5MM; this is not included in 2010 guidance. This acquisition was previously announced and we estimated that the purchase would be $500,000-600,000 accretive to 2010 FFO.
- **Guidance:** Management tightened each end of its 2010 FFO guidance range by $0.01 to $0.37-0.43. Both our estimate and consensus are $0.42 per share. Guidance includes average occupancy of 84-89% and same-store NOI decline of down 6-8%. Q1 occupancy is 85.3% and same-store NOI was -11.5% (GAAP)--Q1 metrics and the lack of revision of guidance suggest that management remains confident that Q1 2010 should be at or near the trough. Guidance also contemplates the refinancing of $500MM in debt, of which $215MM was completed in Q1. DCT has also agreed to terms with its lenders for senior notes totaling $210MM in a private placement offering in April.
- Conference call is today (5/7) at 11am ET, #800-860-2442. Overall core metrics appeared a bit weaker than our expectations, but solid leasing volume and maintaining guidance suggest that improvement may be forthcoming. We'll look for additional color on the core outlook as well as potential for capital recycling.

*Valuation Range Basis & Risks*

High and low-ends based on 5% premium/discount to NAVe. Risks include acquisition timing/velocity and lease-up of domestic and international development projects.

**Industry** Real Estate, Gaming, And Lodging

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Pebblebrook Hotel Trust(PEB) | Donnelly | $18.67 | DEC. | $0.07 | $1.41 | 1/V | $378.3 |

Last Reporting Date: 05/06/2010 After Close

*PEB: Will Have $320MM Post Acquisition, Lowering Ests.*

- SUMMARY. Pebblebrook management continues to see an increase in the volume of acquisition opportunities either through marketed or quiet/exclusive deals and remains confident in its ability to complete what it views as its fair share of acquisitions. PEB announced it signed a P&S for a $67MM hotel in the DC/Baltimore area, its first hotel, with closing expected within 45 days. With ~$320MM in cash post acquistiion, we believe the company is well positioned to acquire at a 30-50% discount to replacement. We estimate 2010-2012 FFO/sh will be $0.07, $1.41, & $1.73, down from $0.14, $1.95 & $2.32. VR is $20-23.
- Q1 ABOVE ESTS. The company reported FFO/sh of ($0.03), $0.02 above our estimate/consensus. G&A costs were inline while interest income accounted for the $0.02 differential. The company currently owns no assets.
- ANNOUNCES AGREEMENT FOR FIRST ACQUISITION. Pebblebrook announced the execution of a P&S for a $67MM hotel in the DC/Baltimore area. Typically a lodging REIT would not announced a P&S, however the SEC mandates disclosure of the agreement as the company is a blind pool REIT and as it would exceed 15% of its fixed assets. The company would have $320MM in cash post acquisition, or $15.75 per share.
- ADJUSTING ESTIMATES. We would expect estimates for the company to move around notably at least until it has fully utilized its initial offering proceeds, which we expect could be by 2012, due to differences in timing, pricing and terms of acquisitions, as well as initial yields, seasonality, and cap ex needs, among other variables. We estimate 2010-2012 FFO/sh will be $0.07, $1.41, and $1.73, down from $0.14, $1.95 and $2.32.
- RECOVERY FASTER THAN INITIALLY EXPECTED, U.S. OUTLOOK UP. Management now expects 2010 U.S. RevPAR to increase 1-3%, up from its prior expectation of flat to down slightly, as provided less than 45 days ago. Business and group demand has improved faster than initially expected, although both segments remain price sensitive. Management expects rate increases to occur before year end, aided by the improvement in higher rated transient demand.

*Valuation Range Basis & Risks*

Pebblebrook has no hotel investments at this time but cash on hand of ~$19/sh; we project full investment by 2012. Our 12-month valuation range is based on 13-14x 2013E EBITDA using 12% discount rates. Risks to achieving our valuation range include acts of/threats of terrorism, slower than anticipated acquisition pace, unfavorable acquisition pricing, inability to leverage acquisitions as expected, or a weak recovery in lodging profits or the broader U.S. economy.

WELLS FARGO SECURITIES

# *Synopsis* - Market Close Packet

**Industry** Technology & Services

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| CGI Group, Inc.(GIB) | Boyer | $14.32 | SEP. | $1.12 | $1.27 | 1/V | $4,184.3 |

Last Reporting Date: 04/28/2010

*GIB: Announces Acquisition of Stanley (SXE)*

- Summary. This morning GIB announced it has entered into a definitive agreement to acquire U.S. Federal Services Provider Stanley (SXE) for $1.07bn (CY11: 16.7x EPS, 9.7x EBITDA). Stanley is one of the most well regarded and fastest growing public companies in the U.S. Federal space. A deal of this nature fits the strategic priorities of GIB's build and buy growth strategy focusing on the U.S. and Western Europe as well as its financial hurdle of being GAAP accretive within the first twelve months (which we do not see being a stretch). We believe the patience management has demonstrated with M&A (last acquisition being AMS in 2004) and the addition of a quality asset in Stanley should ease investors' concerns over the company's build and buy strategy. We have provided Wells Fargo Securities, LLC's SXE model for your convenience (Edward Caso Senior Analyst).
- Terms of the Deal / Funding. GIB has agreed to pay $1.07bn in cash or $37.50 per SXE share. The deal is expected to close by Fall 2010. Break-up fee of $28mm is payable to GIB under customary circumstances. GIB expects to use cash on hand and draw upon its $1.5bn credit facility (Libor +60bps) to fund the acquisition. Post the acquisition the company expects to have a net debt to capitalization ratio between 20-30%, and net debt to EBITDA of 1.1-1.4x which is still within a comfortable range given its strong cash flow. The company will have $600mm of remaining liquidity after the deal.
- Valuation. Based on Wells Fargo Securities, LLC estimates for SXE the transaction is valued at 16.7x CY11 EPS and 9.7x EV/EBITDA. Based on Thursday's close the P/E and EV/EBITDA ranges are 11-15x and 5.5-7.8x, respectively. Stanley's higher growth and margins compared to the group justify the premium, in our view.
- What Stanley Gives CGI. A much larger presence within the U.S. Federal space as combined revenue post the deal is expected to be ~$1.2bn up from $350mm in CY09. An entrance into the Defense and Intelligence side of the Federal market (pre deal Defense & Intel was 1% of Federal rev; Post deal expected to be 55%). Areas of strength for Stanley include systems engineering, Business Process Outsourcing, Biometrics/Cyber security, among others. Post the deal overall revenue from the U.S. is expected to be ~46% up from 33% today.

*Valuation Range Basis & Risks*

Our valuation range is based on 13.0x-14.0x our CY2011 EPS estimate. Risks to our valuation range include a weak economy, revenue concentration with BCE, acquisition integration.

**Industry** Technology & Services

| | Analyst |
|---|---|
| Communication Technology | Lubert |

*Data Networking Weekly Preview*

- **Cisco FQ3 2010 results (5/12).** We expect Cisco to report FQ3 2010 results on Wednesday May 12. We expect Cisco to at least meet our FQ3 2010 sales and non-GAAP EPS estimates of $10.33B and $0.39. Our estimates are above consensus of $10.22B and $0.38 and guidance looking for sales of $10.04-10.28B (+23-26%). Our FQ3 2010 estimates embed gross margin of 65.2% and opex at 36.9% of sales, in line with guidance of 64-65% and 36.5-37%. We believe Cisco benefited from the improved enterprise spending environment, with data center projects a key growth driver. For FQ4 2010, we model sales and non-GAAP EPS of $11.03B and $0.42, above consensus of $10.6B and $0.40. Our FQ4 2010 estimates embed $217MM in sales from Tandberg. We expect management to guide FQ4 2010 sales up 5-7% qtr/qtr and 27-29% yr/yr, gross margin in 64-65% range, and opex of 36.5-37.5% of sales.
- **Citrix Analyst Day (5/12).** We expect Citrix to hold Citrix Synergy 2010's Financial Analyst Track on Wednesday, May 12. The agenda includes Financial and Operating plans as well as Citrix Online, Desktop, and Datacenter & Cloud strategy sessions. Citrix recently reported CQ1 2010 results including sales of $414MM (-8.2% qtr/qtr, +12% yr/yr), exceeding consensus of $408.3MM and management guidance looking for $405-410MM. Additionally, management guided for CQ2 2010 sales of $430-440MM (+3.9 - 6.3% qtr/qtr). Citrix competes in the ADC and WAN Optimization markets. We believe the company's Financial Analyst Track may provide read-through for Cisco, F5, Riverbed, and BlueCoat.

WELLS FARGO SECURITIES

# *Synopsis* - Market Close Packet

**Industry** Technology & Services

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| ExlService Holdings, Inc.(EXLS) | Caso | $16.11 | DEC. | $0.69 | $0.81 | 2/V | $468.8 |

Last Reporting Date: 05/05/2010 After Close

*EXLS: Surprise 2011 Guidance Better Than Expected; Raising Ests*

- **Summary: Strong Q1 Results and Tuck-in Acquisition Drive 2010 Guidance Higher, 2011 Organic Growth Above Expectations.** ExlService (EXLS) reported Q1 revenue of $54MM, up ~29% yr/yr organic, which was better than expected. EPS of $0.19 was well above consensus of $0.13 and our $0.11 estimate. 2010 revenue guidance raised to account for small acquisition and improved visibility, with adjusted operating margin now expected near top of prior 12-14% range. EXLS unexpectedly set 2011 growth target of ~30% including organic expectations of 20% or better. We are raising our 2010 EPS estimate to $0.69 from $0.56 and 2011 to $0.81 from $0.68. Our Valuation Range now $18-19 from $17-18. We reiterate our Market Perform rating with a positive bias.
- **Solid Q1 Results.** Revenue of $54MM was up 33% yr/yr and flat q/q (ex Q4 Aviva payment), and includes one month of recent AmEx captive acquisition. Our and the Street's estimate were $53MM/$52.1MM. Outsourcing revenue was up 25% yr/yr, while more discretionary Transformation services revenue was up 70% yr/yr. Gross margin and continued cost containment drove operating margin to 11.9% and EPS to $0.19, above our/Street estimates of $0.11/$0.13. Seat utilization of 1.27x was flat q/q.
- **2010 Guidance Revision Better Than Expected.** Revenue guided to $235-240MM from $225-230MM and assumes ~$6-7MM from recently acquired PDMA, and greater visibility on demand in H2. Our/Street estimate was $228MM. Adjusted operating margin guidance of 12-14% is reaffirmed and biased toward the top end of range. Guidance for FX hedge gains raised given rupee appreciation.
- **Positive 2011 Guidance Issued Unexpectedly.** EXLS guided 2011 organic growth to 20% plus based largely on current book of business, and expects to add an additional ten points of growth through smaller acquisitions. Our prior estimate was 16% organic; Street 15%. The company is optimistic it can improve upon current adjusted EBITDA (adj op margin less depreciation) levels.

*Valuation Range Basis & Risks*

We expect the shares to trade in a range of $18-19, which is 10-11x our 2010 EV/adjusted operating income estimate. Risks to our valuation range include potential economic/credit driven declines in activity levels, notable client concentration, slow ramp of new facilities, uneven pace of FX gains/losses, integration risk of potential acquisitions, and potential share overhang given 37% ownership by a pre-IPO investor.

**Industry** Technology & Services

Information Technology (IT) Services

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Accenture plc(ACN) | Caso | $41.09 | AUG. | $2.65 | $2.98 | 2 | $29,173.9 |
| CGI Group, Inc.(GIB) | Caso | $14.44 | SEP. | $1.12 | $1.27 | 1/V | $4,219.4 |
| Computer Sciences Corporation(CSC) | Caso | $50.27 | MAR. | $5.10 | $5.25 | 2 | $7,721.5 |
| CACI International Inc.(CACI) | Caso | $47.18 | JUN. | $3.43 | $3.75 | 2 | $1,420.1 |
| DynCorp International, Inc.(DCP) | Caso | $17.02 | MAR. | $1.39 | $1.75 | 2/V | $958.2 |
| ICF International, Inc.(ICFI) | Caso | $22.00 | DEC. | $1.39 | $1.71 | 2 | $424.6 |
| ManTech International Corporation(MANT) | Caso | $43.73 | DEC. | $3.45 | $3.85 | 1 | $1,583.0 |
| NCI, Inc.(NCIT) | Caso | $21.78 | DEC. | $1.62 | $1.78 | 2/V | $296.2 |
| SAIC, Inc.(SAI) | Caso | $17.29 | JAN. | $1.24A | $1.31 | 2 | $6,689.5 |
| SRA International, Inc.(SRX) | Caso | $22.05 | JUN. | $1.26 | $1.37 | 2/V | $1,252.4 |
| Stanley, Inc.(SXE) | Caso | $29.00 | MAR. | $1.90 | $2.05 | 1/V | $698.9 |

*CGI Group Acquiring Stanley For $37.50 In Cash*

- **SUMMARY.** CGI Group (GIB) announced a definitive agreement to acquire Stanley (SXE) for $37.50 per share in cash. This is a valuation level several multiple points above the current government services group trading range, although (in our view) SXE has the best business momentum currently. We expect the consolidation trend to continue, but we note that most publicly traded providers have a controlling shareholder and/or super-voting rights.
- **Transaction Details.** The transaction, which is expected to close in the fall after completing what appears to be normal approval process, values SXE at a little over $1 billion. GIB indicated it will use cash on hand and existing financing arrangements to fund the deal. GIB is holding a conference call at 8:30am (ET)888-789-9572passcode 750086#.
- **Implied Valuation.** Based on our estimates, the transaction values SXE at 16.7x CY2011 EPS ($37.50/$2.25), and an enterprise value/EBITDA of 9.7x ($1.038B/$107MM). Based on Wednesday night's (5/5) close (i.e. before the market chaos), government service providers had P/Es on CY2011E of 12-15x and EV/EBITDAs on CY2011 of 6.0-8.2x. Based on Thursday's close (5/6), CY2011 P/E range is 11-15x and EV/EBITDA range is 5.5-7.8x. Valuation tables are attached.
- **Confirms Consolidating Industry Trend.** Private equity firm Cerberus recently announced an intent to acquire DynCorp (DCP) and now GIB is acquiring SXE. We note a long list of former public government service providers, including AMS, Anteon, SI International, SystemsNet, and Veridian.

# *Synopsis* - Market Close Packet

**Industry** Technology & Services

| | Analyst |
|---|---|
| Information Technology (IT) Services | Caso |

*Wells Fargo Securities' Weekly Services Monitor*

- **HIGHLIGHTS OF THE WEEK - Outsourcing, Systems Integration &Consulting.** CGI Group (GIB, GIB.A) is acquiring U.S. Federal Government Services provider Stanley (SXE) for approx. $1bn. The customer care providers continue to report disappointing results as TeleTech (TTEC) and StarTek (SRT) both missed numbers and lowered their outlooks due to greater than expected volume declines. Hewitt (HEW) reported a strong quarter and maintained guidance. Diamond (DTPI) reported better than expected FQ4 and initial FY11 guidance. We raised our estimates and took up our investment rating to Outperform from Market Perform for this small cap early cycle play on a U.S. economic recovery. Sapient (SAPE) reported a slightly better Q1 and then re-affirmed CY10 and CY11 guidance.
- **HIGHLIGHTS OF THE WEEK - Offshore.** Cognizant (CTSH) reported better than expected CQ1 results and expanded further CY10 revenue guidance to a sector leading 25% plus. While still expressing some caution on the pace of business recovery, especially for discretionary spending, the signs of improvement are growing. We raised our revenue and EPS estimates and enthusiastically reiterate our Outperform rating, especially in this uncertain stock market.
- **HIGHLIGHTS OF THE WEEK - Government.** While the excitement of the week was the GIB-SXE offer, there were some earnings reports as well. NCI (NCIT) reported in-line results, but guided lower on stepped-up new business and infrastructure investments and an unfavorable revenue mix shift. The stock was hit hard in response. After backing out several one-time items, SRA (SRX) reported essentially in-line FQ3 results, and offered FQ4 guidance close to prior expectations.
- **THE WEEK AHEAD.** In the government services space, small cap Global Tech (GTEC) reports Monday after the close and privately held Vangent reports Tuesday morning. Government consultant ICFI Int'l (ICFI) holds its first ever analyst meeting in New York City on Tuesday. IBM is having its "investor briefing" in New York City on Wednesday.
- **INVESTMENT FOCUS Government Services, in general.** Given the proposed acquisition of DynCorp (DCP) by Cerberus and now the proposed acquisition of Stanley (SXE) by CGI Group (GIB), we believe that the government services group should enjoy an upward bias even with ongoing award decision delays limiting revenue upside potential in the near-term.

**Industry** Technology & Services

| Software | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Adobe Systems Inc.(ADBE) | Rueppel | $32.49 | NOV. | $1.94 | $2.16 | 2/V | $20,078.8 |
| Aspen Technology, Inc.(AZPN) | Rueppel | $10.75 | JUN. | ($0.69) | ($0.42) | 1/V | $986.9 |
| Blackbaud, Inc.(BLKB) | Rueppel | $22.01 | DEC. | $0.96 | $1.09 | 2/V | $986.0 |
| Deltek, Inc.(PROJ) | Rueppel | $7.60 | DEC. | $0.47 | $0.54 | 2/V | $492.5 |
| Intuit Inc.(INTU) | Rueppel | $35.21 | JUL. | $2.02 | $2.20 | 2 | $11,739.0 |
| Oracle Corporation(ORCL) | Rueppel | $23.91 | MAY | $1.62 | $1.89 | 1 | $121,367.0 |
| Salesforce.com, inc.(CRM) | Rueppel | $80.90 | JAN. | $1.10A | $1.21 | 1/V | $10,573.6 |
| SuccessFactors, Inc.(SFSF) | Rueppel | $19.84 | DEC. | $0.01 | $0.12 | 1/V | $1,117.0 |
| Unica Corp.(UNCA) | Rueppel | $9.52 | SEP. | $0.37 | $0.60 | 2/V | $222.8 |
| Vocus Inc.(VOCS) | Rueppel | $15.82 | DEC. | $0.61 | $0.68 | 1/V | $313.2 |
| ArcSight, Inc.(ARST) | Rueppel | $21.79 | APR. | $0.55 | $0.71 | 1/V | $767.0 |
| McAfee, Inc.(MFE) | Rueppel | $33.01 | DEC. | $2.65 | $2.95 | 2/V | $5,116.6 |
| Symantec Corp.(SYMC) | Rueppel | $16.53 | MAR. | $1.56A | $1.57 | 1/V | $17,592.9 |
| VMware, Inc.(VMW) | Rueppel | $58.65 | DEC. | $1.31 | $1.53 | 2/V | $24,105.1 |
| Websense, Inc.(WBSN) | Rueppel | $21.89 | DEC. | $1.20 | $1.40 | 1/V | $1,057.3 |

*Enterprise Software Weekly*

- Summary: This week we provide an overview of the relationship between the next-generation data center/cloud computing and storage technology, with a particular focus on the software elements involved. Just as the increasing volume and complexity in enterprise applications is driving new dynamics in compute technology, the increasing volume and complexity in enterprise data is driving new dynamics in storage technology with the cloud computing model again providing the solution. We conclude that although the storage software market is relatively mature and is expected to generate modest growth overall, pockets of high above-category growth will likely emerge in those areas which support and enable the transition to next-generation cloud-based storage architectures.
- Public Company Spotlight: EMC Cloud Storage Initiatives.
- Private Company Spotlight: Acronis, Zetta, Virsto.
- Enterprise Software News.
- Upcoming Events.

# *Synopsis* - Market Close Packet

**Industry** Technology & Services

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| SRA International, Inc.(SRX) | Caso | $21.21 | JUN. | $1.26 | $1.40 | 2/V | $1,204.7 |

Last Reporting Date: 05/06/2010 After Close

*SRX: FQ3 Essentially In-Line; Little Change To The Story/Issues*

- **Summary.** FQ3 revenue of $411 million and pro forma EPS of $0.29 were essentially in-line with our expectations ($400mm/$0.30). FQ3 also included several one-time items related to the struggling Era business, which is expected to continue generating operating losses for now. We are fine-tuning our EPS estimates reflecting adjustment to non-cash, non-operating items. FY10 unchanged at $1.26, FY11 to $1.40 from $1.37, and FY12 to $1.56 from $1.55. Our Valuation Range moves to $19-21 (13-14x CY11 EPS) from $17.50-19.50 to realign valuation with the government services peers. We reiterate our Market Perform rating based on valuation and lack of visible catalyst.

*Valuation Range Basis & Risks*

We expect the shares to trade in a range of $19-21 over the next 6-12 months. This is 13-14X our CY2011 GAAP EPS estimate. Risks include ongoing losses in the Era business, the vagaries of having the U.S. federal government as a client, increasing competition especially as pursued deals get larger, large re-compete exposure in FY10, acquisition assimilation, and potential share overhang from the founder.

**Industry** Technology & Services

| | Analyst | Price | FY | FY10E | FY11E | Rating | M. Cap (MM$) |
|---|---|---|---|---|---|---|---|
| Verisk Analytics, Inc.(VRSK) | Willi | $28.00 | DEC. | $1.33 | $1.48 | 2/V | $5,306.0 |

Last Reporting Date: 05/06/2010 After Close

*VRSK: Q1'10 EPS Ahead On Strong Decision Analytics*

- **Summary:** VRSK's Q1'10 adjusted EPS of $0.33 beat our $0.32 estimate as stronger Decision Analytics (DA) revenue/margins more than offset slightly weaker (than anticipated) Risk Assessment (RA) results. After flowing through greater strength/trends in DA, we are raising our '10/'11E EPS to $1.35/$1.52 from $1.33/$1.48. At this point, we maintain our Market Perform rating. However, given the sideways move in shares over the past several months and the core strength/predictability of the business, shares have become more attractive in light of recent volatility in the market, in our view.
- **Q1'10 Review.** Revenue of $276M (+12% reported and organic) was slightly ahead of our $274M estimate as a ~$1M shortfall in RA was more than offset by strength in mortgage and healthcare solutions in DA as well as strong transactional revenue in loss quantification (also in DA) due to severe weather during Q1'10. Adjusted EBITDA of $124M (+18%) was also $2M ahead of our estimate with actual margin of 44.8% in comparison to our 44.3% estimate. Once again, DA adjusted margins were 200 bps better than our estimate helping to offset slightly weaker margin performance (~100 bps) in DA.
- **2010 Outlook.** Our 2010 revenue/EPS estimates move to $1.152B/$1.35 from $1.143B/$1.33 due primarily to stronger anticipated performance at DA as we are slightly reducing our profitability assumptions for RA. We are now modeling revenue/adjusted EBITDA of $607M/$242M from $599M/$235M. While our RA revenue estimate remains unchanged at $545M, our adjusted EBITDA assumption moves to $265M from $269M as we now only model 30 bps of margin expansion as opposed to our previous estimate of 100 bps.
- **2011 Outlook.** Our 2011 revenue/EPS estimates move to $1.281B/$1.52 from $1.259B/$1.48 due primarily to flowing through stronger performance/trends in DA during 2010 into 2011. We now expect DA revenue of $715M (+18%) vs. our previous $697M estimate. Our adjusted EBITDA margin assumption for DA is now 40.3% vs. our previous estimate of 39.6%.

*Valuation Range Basis & Risks*

We arrive at our valuation range of $30-$32 based on a long-term DCF model. The underlying assumptions in our model are a ten-year nominal free cash CAGR of 9% and a 3% terminal growth rate. Taking the mid-point of our valuation range ($31) implies a P/E of ~23x our 2010E EPS which compares to our universe P/E of 15-16x CY2010E EPS and a higher-quality peer group P/E of 19-20x CY2010E EPS. Risks to our valuation include the loss of a major customer due to client concentration, regulatory risk that would impede spending decisions and the cyclical nature of the insurance and mortgage related businesses.

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**As of: May 7, 2010**

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# *Equity Research*

## Aqua America

**WTR: In-line Q1; Focus On Pending PA And NJ Rate Cases**

**Market Performance**

Sector: Water Utilities
Market Weight

***Earnings Reported***

- **Summary.** Clean Q1. We believe our '10E, '11E and long-term EPS growth estimates remain accurate. Rate relief, in particular the pending PA rate case, is the primary near-term EPS growth driver. Reiterate Market Perform rating. Our positive bias towards WTR's strategy and EPS growth profile is tempered by valuation considerations. On a forward looking basis, shares trade at roughly 19x our 2011E, a modest premium to the water utility 2010 P/E median.

- **Q1 Ongoing EPS of $0.15** (ex $0.01 investment sale gain), in-line with expectations, vs $0.14 last year. Clean Q1 overall with mgmt indicating organic customer growth is beginning to show signs of life, consistent with an improving economy. WTR's efficiency ratio registered a 130 bps improvement over 1Q09.

- **2010 Outlook.** In March, mgmt outlined expectations for 5-7% 1H net income growth accelerating to 7-10% during 2H10. We believe lower than anticipated O&M expense growth led to the 10% growth in ongoing Q1 net income which modestly outpaced mgmt's forecast. Given Q1 is a low usage period that accounts for 15-20% of EPS, we are not adjusting our annual expectations but will continue to monitor the trend. Once the sizeable backlog of rate relief works it way through the income statement over the next 12-18 months and the earned ROEs in currently depressed states improve, we believe WTR's annual EPS growth rate may revert to a more realistic, low-risk regulated rate of 5-7%.

- **EPS Estimates Unchanged.** Our '10E and '11E EPS remain $0.84 and $0.92. Drivers include the usual suspects - rate relief, O&M expense control and M&A growth - as mgmt adheres to its proven strategy. $12.2 mm in rate relief received thus far in '10 and WTR has $65 mm of rate requests pending in 9 states (bulk is PA and NJ) with plans to file an additional $20 mm by year-end. While we do not assume a settlement agreement in the pending $43.2 mm PA rate case, we believe one may be plausible (mgmt made optimistic comments regarding the prospect for both PA and NJ) which could prove our '10E conservative. Also, a return to normal weather would add roughly $0.03 to '10 EPS.

- **Financial Flexibility.** WTR continues to aggressively invest in infrastructure rehabilitation projects utilizing its strong balance sheet and cash flows. We forecast operating cash flow will fund ~85% of 2010's $300 mm CapEx budget. The balance will be achieved through debt and equity (our model reflects ~$30 mm of new equity in 2010) in order to maintain a roughly 45% consolidated equity structure. WTR's strong capital position provides financial flexibility should a significant M&A opportunity arise.

| | 2009A | 2010E | | 2011E | |
|---|---|---|---|---|---|
| **EPS** | | **Curr.** | **Prior** | **Curr.** | **Prior** |
| **Q1** (Mar.) | $0.14 | **$0.15 A** | **0.15** | NE | |
| **Q2** (June) | 0.19 | 0.20 | NC | NE | |
| **Q3** (Sep.) | 0.25 | 0.28 | NC | NE | |
| **Q4** (Dec.) | 0.20 | 0.21 | NC | NE | |
| **FY** | $0.77 | $0.84 | NC | $0.92 | NC |
| **CY** | $0.77 | $0.84 | | $0.92 | |
| **FY P/E** | 22.8x | 20.9x | | 19.1x | |
| **Rev.(MM)** | $671 | $719 | | $773 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

| | |
|---|---|
| Ticker | WTR |
| Price (05/07/2010) | $17.55 |
| 52-Week Range: | $15-19 |
| Shares Outstanding: (MM) | 136.3 |
| Market Cap.: (MM) | $2,392.1 |
| S&P 500: | 1,106.61 |
| Avg. Daily Vol.: | 902,460 |
| Dividend/Yield: | $0.58/3.3% |
| LT Debt: (MM) | $1,393.0 |
| LT Debt/Total Cap.: | 53.4% |
| ROE: | 10.0% |
| 3-5 Yr. Est. Growth Rate: | 6.0% |
| CY 2010 Est. P/E-to-Growth: | 3.5x |
| Last Reporting Date: | 05/06/2010 After Close |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

**Valuation Range: $17.00 to $18.00**

Our VR is based on a relative P/E multiple (applying a ~5% premium to the '10 group median of 18.5X to our '11E EPS) and DDM analyses. Risks include regulatory risk, potential undertaking of dilutive growth ventures and deterioration in the water industry's premium multiple relative to electric utilities.

**Investment Thesis:**

We regard WTR as one of the highest quality, fastest growing water utilities. Strong fundamentals include a growing rate base, largely constructive regulation, a disciplined M&A strategy, relatively low risk EPS growth and a growing dividend. Our Market Perform rating largely reflects valuation considerations.


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**Please see page 2 for rating definitions, important disclosures and required analyst certifications**

## Company Description:

Headquartered in Bryn Mawr, PA, Aqua America (WTR) is one of the largest U.S.-based investor-owned regulated water and wastewater utilities. Aqua America, formally Philadelphia Suburban Corporation (PSC), serves approximately 2.8 million residents in Pennsylvania, Ohio, North Carolina, Illinois, Texas, New Jersey, New York, Indiana, Florida, Virginia, Maine, Missouri, and South Carolina. WTR's largest subsidiary, Aqua Pennsylvania, accounts for approximately half of the company's total customer base. The company's aggressive, yet disciplined, growth-through-acquisition strategy has resulted in more than 130 acquisitions and growth ventures adding roughly 250,000 customers over the last five years.

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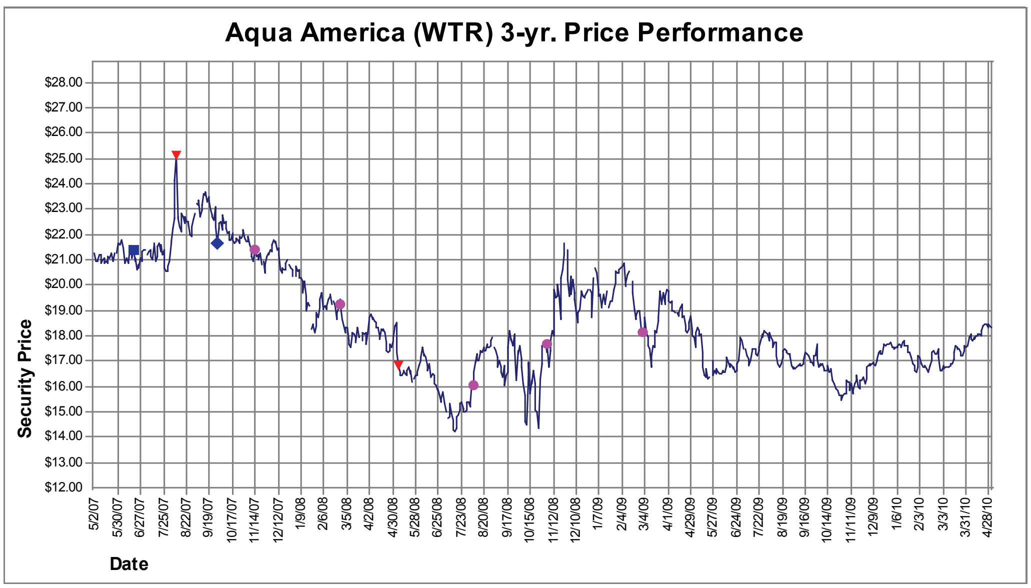


| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 5/2/2007 | | Winter | | | |
| | 5/2/2007 | NA | 1 | 25.00 | 25.00 | 21.27 |
| ■ | 6/19/2007 | | Kalton | | | |
| ▼ | 8/9/2007 | NA | 2 | NE | NE | 25.07 |
| ◆ | 9/28/2007 | NA | NR | NE | NE | 21.62 |
| ● ◆ | 11/14/2007 | 22.34 | 1 | 24.00 | 26.00 | 21.39 |
| ● | 2/27/2008 | 19.57 | 1 | 22.00 | 23.00 | 19.24 |
| ▼ ● | 5/7/2008 | 17.99 | 2 | 19.00 | 20.00 | 16.80 |
| ● | 8/6/2008 | 16.42 | 2 | 17.00 | 18.00 | 16.01 |
| ● | 11/5/2008 | 18.04 | 2 | 18.00 | 19.00 | 17.65 |
| ● | 3/2/2009 | 18.40 | 2 | 17.00 | 18.00 | 18.13 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
▼ Rating Downgrade
▲ Rating Upgrade
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◆ Initiation, Resumption, Drop or Suspend
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May 7, 2010

# *Equity Research*

## Brookfield Asset Management

**BAM: The Playing Out Of GGP Situation Highlights Why We Like BAM**

**Outperform / V**

Sector: Infrastructure & Specialty
Market Weight

***Company Note***

- The Wall Street Journal reported this morning (5/7) General Growth (GGP), in a hearing scheduled with Judge Gropper later today, will seek to affirm the recapitalization proposal from the BAM-led consortium as the interim option for GGP. For details see the squawk from fellow REIT analyst Jeff Donnelly, "GGP: BAM May Have It. Pershing Square May Drop Warrants." We view the playing out of the GGP situation as a microcosm of many of the reasons we like BAM:
- **(1) BAM is disciplined with its investment strategy.** BAM has made very few adjustments to its original offer for GGP--the warrant package was tweaked a little, but essence of its bid has remained at $10 per share for GGP and $5 per share for GGO. This is consistent with BAM's deal-making strategy over the years. We feel comfortable BAM will continue to be a strong allocator of capital.
- **(2) BAM is viewed as a strong partner** for both coinvestors and investees. Track record and reputation is attracting interest from investment partners, which we believe should have positive benefits for AUM growth. BAM is often viewed favorably by companies it seeks to invest in, generally allowing BAM to win competitive bids where it's not the highest bidder. We believe this will continue to be a big plus for BAM as it ramps up investment activity.
- **(3) BAM doesn't need GGP**. BAM is seeing significant external investment opportunities. BAM noted on its conference call (5/6) that it's seeing a significant amount of opportunities, and the trouble is identifying the really great opportunities from merely great ones. This is in contrast to most of the REITs we cover that have expressed difficulty finding attractive opportunities.
- **(4) BAM doesn't need GGP**. It has significant internal growth opportunities. BAM isn't planning to monetize significant amounts of assets in the near term because it believes existing asset base has a lot of growth potential. This could be viewed as a cop-out if it weren't active on the deal front, but it is, so this position appears logical, in our view.
- Shares trade at a relative discount versus REITs. Current estimated sum-of-parts value is $24+ per share, but we believe there is significant upside potential over the next few years--AUM growth could generate $8+ per share of incremental value ($5+ per share of NPV), and there is significant potential upside in power operations. Overall, investment in GGP may not be material to total value of BAM, but its actions--whether or not it wins or loses GGP--highlight why BAM is a good investment, in our view.

| | 2008A | 2009E | | 2010E | |
|---|---|---|---|---|---|
| **CASH EPS** | | **Curr.** | **Prior** | **Curr.** | **Prior** |
| **Q1** (Mar.) | $0.65 | $0.39 A | NC | $0.37 | NC |
| **Q2** (June) | 0.54 | 0.43 A | NC | 0.41 | NC |
| **Q3** (Sep.) | 0.46 | 0.28 A | NC | 0.37 | NC |
| **Q4** (Dec.) | 0.47 | 0.37 | NC | 0.44 | NC |
| **FY** | $2.12 | $1.48 | NC | $1.60 | NC |
| **CY** | $2.12 | $1.48 | | $1.60 | |
| **FY P/E** | 11.4x | 16.3x | | 15.0x | |
| **Rev.(MM)** | $11,508 | $10,595 | | $7,831 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

| | |
|---|---|
| Ticker | BAM |
| Price (05/07/2010) | $24.06 |
| 52-Week Range: | $15-27 |
| Shares Outstanding: (MM) | 579.0 |
| Market Cap.: (MM) | $13,930.7 |
| S&P 500: | 1,122.64 |
| Avg. Daily Vol.: | 982,649 |
| Dividend/Yield: | $0.52/2.2% |
| LT Debt: (MM) | $18,602.0 |
| LT Debt/Total Cap.: | 57.8% |
| ROE: | 21.0% |
| 3-5 Yr. Est. Growth Rate: | 13.0% |
| CY 2010 Est. P/CASH EPS-to-Growth: | 1.2x |
| Last Reporting Date: | 11/06/2009 Before Open |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

**Valuation Range: $24.00 to $27.00**
Low-end based on NAVe mid-pt; high-end = 10% premium. Risks: Organizational complexity and investments in public companies could lead to conflicts of interests upon divestitures and investments; significant income in recent years has been derived from monetization and trading gains, which could be reduced.

**Investment Thesis:**
BAM has narrowed its focus to property, power and infrastructure investments (primarily), and is migrating more towards an asset management platform. Sharpening its investment parameters and increasing management fees should enable continued robust cash flow growth, with less volatility.

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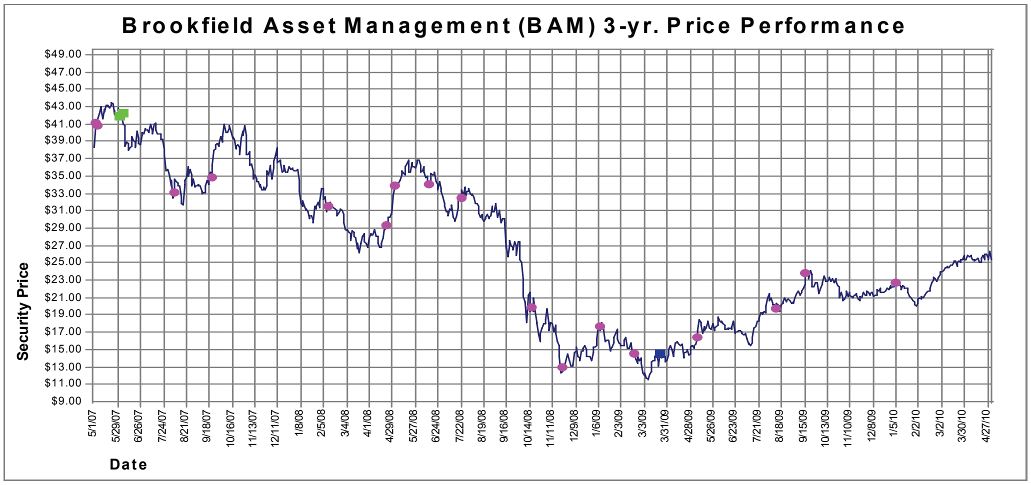
## Company Description:

Brookfield Asset Management is an investment company with operations in North American, European and Australasian property, North American and Brazilian power generation (hydro), and global infrastructure asset management. The company has a long-standing history of operational performance and presence in each of its operating localities. Brookfield invests directly, and indirectly through its subsidiaries, in both public and private companies.

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 5/1/2007 | | Haley | | | |
| | 5/1/2007 | NA | 1 | 32.00 | 38.00 | 38.33 |
| ● | 5/2/2007 | NA | 1 | 38.67 | 44.00 | 41.09 |
| ● | 5/3/2007 | NA | 1 | 40.00 | 44.67 | 40.80 |
| ❐ | 6/1/2007 | | 3-for-2 stock split | | | |
| ● | 8/6/2007 | NA | 1 | 38.00 | 43.00 | 33.14 |
| ● | 9/20/2007 | 36.00 | 1 | 38.00 | 42.00 | 34.86 |
| ● | 2/11/2008 | 31.43 | 1 | 33.00 | 40.00 | 31.53 |
| ● | 4/22/2008 | 29.57 | 1 | 30.00 | 37.00 | 29.31 |
| ● | 5/1/2008 | 32.72 | 1 | 31.00 | 38.00 | 33.91 |
| ● | 6/12/2008 | 34.00 | 1 | 35.00 | 38.00 | 33.98 |
| ● | 7/22/2008 | 32.14 | 1 | 35.00 | 41.00 | 32.47 |
| ● | 10/16/2008 | 19.51 | 1 | 29.00 | 36.00 | 19.93 |
| ● | 11/24/2008 | 12.41 | 1 | 24.00 | 31.00 | 13.00 |
| ● | 1/8/2009 | 17.69 | 1 | 19.00 | 22.00 | 17.69 |
| ● | 2/18/2009 | 14.37 | 1 | 19.00 | 23.00 | 14.50 |
| ■ | 3/23/2009 | | Maiorana | | | |
| ● | 5/6/2009 | 16.45 | 1 | 18.00 | 22.00 | 16.45 |
| ● | 8/11/2009 | 19.74 | 1 | 20.00 | 24.00 | 19.74 |
| ● | 9/16/2009 | 22.54 | 1 | 23.00 | 25.00 | 23.75 |
| ● | 1/5/2010 | 22.30 | 1 | 24.00 | 27.00 | 22.65 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- ❐ Split Adjustment

**Rating Code Key**
- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

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**2=Market Perform:** The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD
**3=Underperform:** The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

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**VOLATILITY RATING**
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As of: May 7, 2010

| | |
|---|---|
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May 7, 2010

# *Equity Research*

## Celgene Corp.

**CELG: Looking Forward to ASCO**

**Outperform**

Sector: Biotechnology
Market Weight

***Company Note***

- **Summary.** Celgene's outstanding "beat and raise" quarter was driven predominately by Revlimid which despite reaching a $2+ billion annual run rate, grew an impressive 46% year-over-year. Global expansion, share gains in earlier lines of therapy across major markets, and increasing treatment duration remain in the near-term growth engines. We now turn to the American Society of Clinical Oncology (ASCO) June 4-8, where important new data is to be presented that has the potential to support future growth. Overall, we look forward to seeing over 50 abstracts and more than 10 oral presentations. Abstract titles have already been posted with the full content posted on May 20 at 6 p.m. EST. At this venue, definitive evidence from prospective randomized trials emerge in the field of myeloma that should change prescribing habits. KOLs have noted that following the presentation of CALGB 100104 and IFM-2005-02 it will be unethical to not prescribe Revlimid in the maintenance setting. We still believe the financial impact of continuous dosing is underappreciated; indeed it should help drive hematology-oncology total revenues to $6 billion in 2015. Behind this we expect to Revlimid + Rituxan in lymphoma to continue to impress.
- **Maintenance Expectations**. For us, the more interesting maintenance data set is from IFM 2005-02 because it is more robust (longer follow-up, more patients) and it answers key questions about the impact of maintenance following consolidation (which could have negated the benefit of Rev maintenance). During recent conversations with consultants who have intimate knowledge of the maintenance studies, it was underscored that the results from the CALGB and IFM trials are very concordant. We expect an impressive ~60% delay in in the risk of tumor progression for Revlimid and 2-yr survival of ~95%.
- **Keen Interest in Lymphoma**. Beyond myeloma, our attention remains on data that will have the greatest implications for future long-term growth, namely results from studies in NHL. Although there are 180k myeloma patients eligible for Revlimid in the U.S., E.U.-5 and Japan, there are 225k eligible follicular lymphoma patients and 260k eligible diffuse B-cell lymphoma patients. Updated results from Fowler evaluating the combination of Revlimid and Rituxan are expected to build on the impressive results presented at ASH 2009.
- **Elimination of Transplant?** At ASCO 2010, updated results from a trial comparing an all oral regimen to high-intensity transplant are to be presented. Recall, at ASH 2009, a similar PFS emerged from this presentation.
- **Other Noteworthy Data Sets.** Amrubicin in lung cancer, Istodax in lymphoma and Revlimid in prostate cancer and CLL

| | 2009A | 2010E | | 2011E | |
|---|---|---|---|---|---|
| **EPS** | | **Curr.** | **Prior** | **Curr.** | **Prior** |
| **Q1** (Mar.) | $0.44 | **$0.63 A** | **0.60** | NE | |
| **Q2** (June) | 0.46 | 0.65 | NC | NE | |
| **Q3** (Sep.) | 0.56 | **0.67** | **0.70** | NE | |
| **Q4** (Dec.) | 0.62 | **0.70** | **0.72** | NE | |
| **FY** | $2.08 | $2.66 | NC | $3.49 | NC |
| **CY** | $2.08 | $2.66 | | $3.49 | |
| **FY P/E** | 27.9x | 21.8x | | 16.7x | |
| **Rev.(MM)** | $2,690 | $3,428 | | $4,214 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

| | |
|---|---|
| Ticker | CELG |
| Price (05/06/2010) | $58.10 |
| 52-Week Range: | $38-66 |
| Shares Outstanding: (MM) | 460.3 |
| Market Cap.: (MM) | $26,743.4 |
| S&P 500: | 1,128.15 |
| Avg. Daily Vol.: | 4,620,090 |
| Dividend/Yield: | $0.00/0.0% |
| LT Debt: (MM) | $0.0 |
| LT Debt/Total Cap.: | 0.0% |
| ROE: | 10.0% |
| 3-5 Yr. Est. Growth Rate: | 25.0% |
| CY 2010 Est. P/E-to-Growth: | 0.9x |
| Last Reporting Date: | 04/29/2010 Before Open |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

**Valuation Range: $74.00 to $82.00**
We value Celgene by applying a 28-34x P/E multiple to our 2011 EPS estimate of $3.49, discounted 15-20%, to arrive at a valuation range of $74.00-82.00. Celgene faces a Teva thalidomide ANDA challenge and Revlimid competitive pressures.

**Investment Thesis:**
Celgene has one of the highest growth rates in biotechnology driven by the global expansion of Revlimid which, in our opinion, is poised to become a multi-billion dollar drug and one of the most successful cancer treatments.

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**Please see page 11 for rating definitions, important disclosures and required analyst certifications**

## Company Description:

Celgene Corporation, based in Summit, New Jersey, is a leading U.S. blood cancer company that is expanding its international reach through the acquisition of Pharmion to become a global leader in the fields of oncology and inflammatory diseases. Celgene is developing proven, proprietary, and novel classes of disease-altering drugs that include immunomodulatory and epigenetic agents as well as cell-signaling inhibitors and placental stem cell therapies. Celgene's hallmark product is Revlimid (CC-5013, lenalidomide) approved for use in treatment of myelodysplastic syndrome (MDS) in patients with the chromosome 5q deletion and for the treatment of multiple myeloma (MM) in patients who have failed one prior therapy. Celgene's goal is to develop Revlimid into a global blockbuster. To that end Revlimid is being evaluated as front-line therapy for MM in newly diagnosed patients, MDS patients without the 5q deletion, and in patients with non-Hodgkin's lymphomas, chronic lymphocytic leukemia and a variety of solid tumors. Celgene complements its growing Revlimid revenues with sales of Thalomid in oncology, and royalties on its family of Ritalin products for attention deficit hyperactivity disorder (ADHD) from Novartis. However, the acquisition of Pharmion bolstered Celgene's position for becoming a global leader in hematology-oncology through the addition of Vidaza. Celgene's pipeline is highlighted by Actimid for hematological cancers and CC-10004 and CC-11050 for inflammatory and auto-immune conditions such as psoriasis and psoriatic arthritis. Its stem-cell and tissue products division has positioned Celgene to be a future player in this emerging space.

### ASCO 2010 Is Just The Beginning

*Revlimid* is the 7th most valuable oncology therapy based on total revenues and growth is far from over. Market expansion through new regulatory approvals in additional geographies and expanded label indications in existing markets remain important growth drivers for *Revlimid*. However, one the greatest near-term drivers is the extension of duration derived from continuous dosing. The intent of continuous treatment is to maximize response rate and depth of response, while delaying progression in an effort provide long-term sustained disease control. Less than one percent of hematology-oncologists globally use *Revlimid* continuously or in a maintenance capacity across all eligible patient populations. At present in the U.S. myeloma market where the greatest prevalence of maintenance or continuous *Revlimid* dosing exists, only a minority of clinicians use *Revlimid* in a continuous maintenance capacity after achievement of remission or plateau phase following induction therapy.

ASCO 2010 will be the first venue in which definitive evidence from prospective randomized trials will emerge in the field of myeloma that should change prescribing habits. Together, results from the *Revlimid* Ph. III MM continuous dosing studies: CALGB 100104 (transplant eligible), and IFM-2005-02 (transplant eligible post consolidation), supported by MM-015 (transplant ineligible) presented at ASH 2009, should result in a new standard-of-care. We can now say without doubt, maintenance is important for prolonging remission duration and *Revlimid* we believe will be the drug of choice for maintenance therapy given its ease of administration and tolerability profile. Dr. San Miguel noted, “I believe lenalidomide is likely to be the pre-eminent maintenance agent in myeloma.” Other KOLs have echoed similar beliefs. Regardless of how modeled, we believe *Revlimid* will remain the key maintenance component with the clinical goal being to maintain patients on 10 mg daily for 2 years, equating to revenue of $140k-$150k per patient.

### CALGB 100104 Outlook (Abstract #8017)

Recall, that at this time, very little information was provided on the CALGB 100104 trial and virtually no data was provided for the IFM 2005-02 thus, we sought insight into these trials. Together, these trials definitely and undeniably show the benefit of *Revlimid* maintenance.

On Friday December 18, 2009, it was announced that the CALGB 100104 trial was stopped early by the data safety and monitoring committee (DSMB) after an interim efficacy analysis conducted in September showed a statistically significant improvement in time to disease progression favoring the *Revlimid* maintenance arm. CALGB 100104 is a randomized Phase III study of lenalidomide versus placebo as maintenance therapy after autologous stem cell transplantation for patients with multiple myeloma. These data add another layer of evidence, suggesting that continuous *Revlimid* administration is important for prolonging remission duration and extending survival.

Eligibility for the CALGB 100104 trial essentially allowed for the use of any induction regimens, as well as, for up to 2 different regimens (not including high-dose dexamethasone) in the event the first was not well-tolerated by the patients required a modification. Important to many investors is the benefit of *Revlimid* maintenance following RD induction, although this combination was used in a minority of patients, insight into this regimen strategy will be gained.

Patients with Stage 1-3 multiple myeloma, who were less than 70 years of age and received 3-4 cycles of chemotherapy and within 1 year of initiation of therapy, were eligible. Patients were stratified at registration by levels of beta2-microglobulin and prior IMiD use as part of the induction regimen. As part of the stem cell mobilization, patients received high-dose cyclophosphamide IV over 2-3 hours on day 1 OR IV over 1 hour every 3 hours three times on day 1. Patients also receive filgrastim (G-CSF) subcutaneously (SC) once daily beginning after day 0, before or on day 5 and continuing until PBSC collection is complete. Patients then undergo leukapheresis for collection of PBSC. Approximately 2-4 weeks after PBSC collection, patients receive melphalan IV over 30-60 minutes on day -2. Patients undergo autologous PBSCT on day 0. Patients receive G-CSF SC once daily beginning on day 5 and continuing until blood counts recover.

**Phase III Randomized Study of Lenalidomide as Maintenance Therapy After Autologous Stem Cell Transplantation in Patients With Multiple Myeloma**

**Primary Endpoint and Statistical Assumptions**

1. Time to disease progression (TTP): Efficacy of lenalidomide vs placebo as maintenance therapy after autologous stem cell transplantation, in terms of prolonging time to disease progression, in patients with multiple myeloma. The trial was designed to enroll 544 patients and randomize 462 patients to show a 9.6 mos difference in TTP favoring the Revlmid maintenance arm. There were 6 interim analyses and one final analysis conducted as part of the trial design.

**Secondary Endpoint Hierarchy**

1. Progression-free Survival
2. Overall survival
3. Complete response rate conversion post-ASCT
3. Feasibility of long-term treatment with lenalidomide

**Prior/Concurrent Therapy:**

1. Prior thalidomide or lenalidomide allowed provided treatment duration was ≤ 12 months
2. Prior therapy allowed provided treatment duration was ≤ 12 months

**Key Dates and Summary Results**

The first interim analysis was conducted in June 2008, with the most recent interim analysis conducted triggered in September 2009. The study closed to enrollment on July 2, 2009 after 568 patients were enrolled. Friday December 18, 2009, that the CALGB 100104 trial was stopped early by the data safety and monitoring committee (DSMB) after an interim efficacy analysis demonstrated Revlimid maintenance resulted in a 58% reduction in the risk of disease progression.

**Trial Design**

| Screen | Transplant | | Restaging Days 90 - 100 | Randomization | Rx Until Progression |
|---|---|---|---|---|---|
| Stage 1-3, Rx 2-4 cycles, ≤ 1 Year from Rx Initiation. | Peripheral blood stem cell (PBSC) collection of ≥ 2 x 10^6 CD34+ cells/kg and preferably 5 x 10^6 cells/kg. | Mel 200 + ASCT within 4-6 weeks of registration | Patients with CR, PR, SD were enrolled and randomized 1:1 | | Placebo |
| | | | | | Revlimid 10 mg (Dose adjustments 5 - 15 mg allowed) |

Source: Wells Fargo Securities, LLC

Patients were then re-staged between day 90 to 100 after completion of autologous PBSCT. Eligibility for randomization were that patients have stable disease or better. Patients with disease progression were removed from the study. Patients with responding or stable disease were stratified according to levels of β2 microglobulin at baseline (≥ 2.5 mg/dL vs normal), prior thalidomide (yes vs no), and prior lenalidomide (yes vs no). Stable patients were randomized 1:1 to either placebo or continuous *Revlimid* 10mg maintenance treatment. Maintenance therapy began between day 100 -110. There was a possible dose escalation at 3 months to 15 mg *Revlimid* or placebo, in ANC > 1000, platelets >75,000 and if blood counts drop there was the option for descalation by increments of 5 mg daily or 5 mg three weeks on, 1 weeks off. **Arm I:** Beginning between day 100-110, patients receive oral lenalidomide once daily. The maintenance dose is increased to a maximum dose of 3 pills over 3-6 months **Arm II:** Beginning between day 100-110, patients receive oral placebo once daily.

After completion of study treatment, patients are followed for a total of 10 years; every 3 months for 4 years, every 6 months for 5 years, and then annually for 6 years. The interim analysis demonstrated that patients on placebo had a median TTP of 25.9 months and that *Revlimid* maintenance resulted in a 58% reduction in the risk of disease progression (the median TTP for the *Revlimid* maintenance arm was not yet reached). Thus, we estimated that CALGB 100104 should show a median time to tumor progression (TTP) of at least 41 months and KOLs have corroborated these assumptions.

### IFM 2005-02 Out Look (Abstract #8018)

On January 13, 2010, it was announced that the IFM 2005-02 Phase III trial conducted by the Intergroupe Francophone Du Myelome (IFM) evaluating continuous *Revlimid* following transplant met its primary endpoint. For us, the more interesting maintenance data set is from the IFM 2005-02 because it is more robust (longer follow-up, more patients) and it answers key questions about the impact of maintenance following consolidation (which could have negated the benefit of Rev maintenance). Further, given that patients from IFM 99-01 were enrolled into this trial, more than 50% will have received induction with

*Velcade*+dexamethasone (dex), complementing the ECOG E4A03 trial which used *Revlimid*+dex for induction.

From July 2006 to August 2008, 614 myeloma patients under the age of 65 years (median age = 56), with non progressive disease after a first line autologous stem cell transplant (ASCT) performed within 6 months were enrolled in the IFM 200502 protocol. 79% of patients had DS III disease and adverse cytogenetics occurred in more than half of patients (del 13 = 212/538, t 4-14 =38/538, del 17p=47/538). The induction regimen [VAD (48%), *Velcade*/dex (46%), thal/dex (2%), or another regimen (4%)] was followed by either a single transplant (79%) or a tandem transplant (21%). Enrolled patients were to receive a consolidation treatment with *Revlimid* (25 mg/d, po, 21 days/month, for 2 months) followed by a maintenance treatment with *Revlimid* (10 to 15 mg/d) or placebo till relapse. Data presented at ASH 2009 demonstrated that *Revlimid* consolidation was found to significantly improve the number of patients who received a complete response (sCR/CR rate; p=0.0005). Approximately 90% of patients had a very good partial response (VGPR) or better following *Revlimid* consolidation which left open the question of whether or not there would be further benefit derived from maintenance *Revlimid* therapy. Given the trial achieved significance at the interim, clearly benefit was derived from maintenance *Revlimid*

During recent conversations with consultants who have intimate knowledge of the maintenance studies, it was underscored that the results from the CALGB and IFM trials are very concordant. Recall the CALGB trial showed an impressive 58% reduction in risk of tumor progression. Further, we expect a median progression free-survival (PFS) of greater than 40 months to emerge from the IFM 2005-02 study, given the trial was designed to show a 40 month median PFS. However, it is likely much greater than this given that a median has not yet been reached and there is likely 60% reduction in the time to progression. Most Important, benefit was seen in all patient categories; those with adverse cytogenetics, those with VGPR post consolidation etc.

We note that clinicians are not focused on survival in these trials because the measure will be confounded by the fact that patients in the placebo arm received *Revlimid* upon immediate progression.

**MM-015 Update (EHA)**

Unlike, CALGB 100104 and IFM 2005-02, MM-015 is a Celgene sponsored 3 arm trial Phase III trial evaluating *Revlimid* in combination with melphalan and prednisone (RMP) with and without continuous *Revlimid* (+R) versus melphalan and predisone (MP); Arm A RMP +R, Arm B RMP+ placebo and Arm C MP + placebo. Update results from MM-015 are unlikely to emerge at ASCO 2010 but will likely be presented at EHA. Although we may see 70% of the planned progression events versus the prior 50% of events, we do not expect a different picture to emerge when evaluating Arm B versus C induction regimens due to the unconventional lower doses of both melphalan (0.18 vs 0.25) and *Revlimid* (10 mg vs 25 mg) used in the trial, as well as, the dose modification strategy (both melphalan and *Revlimid* doses were lowered upon toxicity presentation). Further, 50% of patients in the MP arm received *Revlimid* 25 mg +/- dexamethasone confounding the median PFS. Recall, going into the initial MM-015 data presentation at ASH 2010, investors were most concerned with a difference between Arm A (MPR+ continuous *Revlimid*) showing a PFS difference compared to Arm B (MPR + placebo). Indeed, a dramatic difference between Arm A and B emerged as demonstrated by a Hazard Ratio (HR) of 0.530. However, no one expected there to be virtually no difference for PFS between arm B and Arm C (MP only).

This trial used a dose of 10 mg *Revlimid* induction dose versus the standard 25 mg however the patients had worse disease than typically seen in other Phase III transplant ineligible trials. (50% had ISS III) yet an unprecedented 50% reduction of risk for progression or death was achieved for the MPR+R arm vs. MP. By design the trial use a less intensive induction regimen with the understanding that potency would be diluted, however drop-out would be reduced due to less toxicity. Indeed, only 16% of patients dropped out of the trial; febrile neutropenia was only <7%, there was no Grade 3/4 peripheral neuropathy (only 1% Grade 2) and there was no neuropathic pain over the course of 25-30 months of therapy. By comparison, VMP in the VISTA study showed a 39% risk reduction (vs. MP). However, over just 9 months of therapy, 34% of patients drop-out of the trial due to 36% have neuropathic pain. The MPT regimen is associated with a 40% discontinuation rate (see comparison charts).

However, no KOLs we have spoken with cared about the lack of separation between arm B and C of the MM-015 trial because of the lower than normal *Melphalan* dose used and the dose reduction methodology employed. Rather, MM-015 sends a clear message to clinicians that there is dramatic benefit to using *Revlimid* continuously. To this end, a landmark analysis evaluating the benefit derived from *Revlimid* maintenance following the initial induction therapy showed that continuous *Revlimid* was associated with 75% reduction in the risk of progression.

**Continuous Revlimid Reduces the Risk of Progression**

| | Risk of Progression | Discontinuation Rate |
|---|---|---|
| MPT | **-37%** (meta-analysis) | 40% |
| MPV | **-44%** (VISTA) | 36% |
| MPR+R | **-50%** (MM-015) | 16% |

Source: Wells Fargo Securities, LLC

Regardless, in the future the alkylating agent melphalan (RMP) may be replaced by low-dose dexamethasone (Rd) based on data from Gay et al. comparing the *Revlimid*/dexamethasone (Rd) combination vs. MPR as primary therapy for newly diagnosed elderly MM patients, to determine the additive value of melphalan compared to a regimen of lenalidomide plus corticosteroid.

**Elimination of transplant?**

At ASCO 2010, updated results form a trial comparing an all oral regimen to high-intensity transplant will be presented which is important to the future consideration of the treatment algorithm. Recall, at ASH 2009, Dr. Palumbo also presented interim results from a prospective, randomized study of melphalan, prednisone, lenalidomide (MPR) versus melphalan (200 Mg/M2) and autologous transplantation (Mel200) in newly diagnosed myeloma patients younger than 65 years. All patients are re-randomized to *Revlimid* maintenance following transplant / MPR respectively.

Although there is a slightly higher response rate for transplant, the progression-free survival (PFS) is very similar between the arms (91%) with the caveat that the follow-up has been short in duration. Safety favored the all-oral regimen. In the future, this trial, and others like it, should be able to inform clinicians which patients can forego initially or altogether. In the meantime, ASCT is being offered to patients under the age of 65 followed by a minimum of 12 months of *Revlimid* consolidation/maintenance. Note, as an alternative to maintenance, 4 cycles of *Revlimid* consolidation is used to convert some patients who are in VGPR into CR or molecular responses. These data are key to driving early upfront *Revlimid* use in Europe.

In the following exhibit we highlight the four newly diagnosed myeloma *Revlimid* studies which will support label expansion (the MM-015 study of melphalan, prednisone, and *Revlimid* (MPR) plus *Revlimid* maintenance therapy supported by the ECOG E4A03, SWOG SO 232 and CALGB 100104 studies). The purpose of the exhibit is to highlight that the results present in the four completed studies are supportive of broad labeling claims that we believe have a strong likelihood to mimic language in the *Thalomid* and *Alimta* labels. First, positive studies have been conducted in both transplant eligible and ineligible patients allowing for approved use of *Revlimid* in both populations. Second, not withstanding questions about aspects of the SWOG and ECOG studies it appears that *Revlimid* is sufficiently efficacious in combination with both dexamethasone and with melphalan and prednisone. This is important as both regimens may be used in differing degrees in the U.S. and Europe. We note that the objective response rates (ORR) and the one-year overall survival (OS) in these studies are consistent even though all three studies used different *Revlimid* dosing regimens. MM-015 evaluated 10mg days 1-21 per 28 day cycle. ECOG E4A03 evaluated 25mg days 1-21 per 28 day cycle. SWOG evaluated 25mg days 1-28 of a 35 day cycle. Similarly the dexamethasone doses differed.

**Studies to Support a Front-Line and Continuous Maintenance Dosing Approval for Revlimid in NDMM**

| | Studies to Support Licensing in the NDMM Population: ASCT Eligible and Ineligible | | | | | | | Supportive Ongoing Studies in ASCT Eligible and Ineligible | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Author | Palumbo | | | Rajkumar | | Zonder | | McCarthy | IFM 2005-02 | | Palumbo | |
| Publication/Study | #613, ASH 2009, MM-015 | | | ECOG E4A03 | | SWOG SO232 | | CALGB-100104 | #429, ASH 2009 | | #350, ASH 2009 | |
| | Trans Ineligible | | | Transplant eligible | | Transplant eligible | | Transplant eligible | Transplant eligible | | Tramsplant Eligible/Ineligible | |
| Median Age | 71 years | | | 65 years | | 65 years | | <70 | 56.5 years | | 58 years | |
| Relevance | EU/US Front-line Registration Study<br><br>Evaluate R as maintenance regimen | | | Less toxic up-front regimen<br><br>US Front-line Registration | | US Registration<br><br>Induction + maintenance | | R maintenance post-ASCT | R consolidation post-ASCT<br><br>R Maintenance vs. none | | Multiple: See comments<br><br>Rd induction & R maintenance | |
| Primary Endpoint | PFS; 9 cycles | | | ORR @ 4 months | | PFS; 3 induction cycles | | TTP | Improve CR/sCR rate | | PFS; 4 cycles Rd for induction | |
| Regimen | RMP+R "A" | RMP+Pbo "B" | MP "C" | RD | Rd | RD | D | R | Pre-consolidate | Post-consolidate | MPR | Mel 200 |
| Revlimid Dose | **10mg** d1-21 + as maintenance in RMP+R | | | 25mg d1-21 | 25mg d1-21 | 25mg d28/35 days | 40mg d1-4, 9-12, 17-20 | 10 mg/day (can increase to 15 mg or deacres to 5mg) | Consolidation dose of R 25mg d1-21 for 2 cycles | | Both arms Rd induction 4 cycles. R=25mg d1-21; d=40mg d1, 8, 15, 22 | |
| Dose for Combination | M=0.18 mg/kg, day 1-4, P=2mg/kg, days 1-4 | M=0.18 mg/kg, day 1-4, P=2mg/kg, days 1-4 | - | D=40mg d1-4, 9-12, 17-20 | d= 40mg d1, 8, 15, 22 | D=40mg d1-4, 9-12, 17-20 | N/A | N/A | Maintenance dose is **R 10mg or 15mg** or placebo until relapse. | | 6 cycles RMP; R=**10mg** d1-21 | Mel 200 tandem transplant |
| "N" | 152 | 153 | 154 | 223 | 222 | 100 | 98 | TBA | 412 | | 202 | 200 |
| ORR | **77%** | 67% | 49% | 82% | **71%** | **75%** | 48% | TBA | Pre-consolidation: CR+sCR 24%, VGPR 50%, PR 25%, SD 3% | | **90%** | 97% |
| CR | 18% | 13% | 5% | 4% | 2% | 15% | 2% | TBA | | | 14% | 25% (p=0.19) |
| VGPR | 32% | 33% | 11% | 52% | 42% | 47% | 17% | TBA | 60 pts ↑ response post-consolidation. ***R improved sCR/CR rate, p=0.0005*** | | 42% | 37% (p=0.31) |
| PR | 45% | 34% | 37% | 30% | 29% | 14% | 29% | TBA | | | 34% | 35% |
| 1-year OS | **92%** | - | - | 87% | **96%** | **93%** | 91% | TBA | - | - | **97%[$]** | 98%[$] (p=0.27) |
| 2-year OS | Data too immature. Not reported. | | | 75% | 87% | - | - | TBA | - | - | - | - |
| TTP (%) | | | | | | | | 58% Reduction | | | | |
| PFS (months) | **Not reached** | 13+ | 13 | - | - | | | | - | - | 96% | 94% |
| PFS 1-Yr | | | | | | 77% | 55% | | | | | |
| Comments | Palumbo: OS is not major endpoint any longer; ***PFS is more relevant***. 5-year OS most important OS result. | | | Less toxic dex dose translates into lower respone but improved outcomes. | | R maintenance 25mg d1-21 and a non-typical R dosing schedule. | | Continuous Revlimid a median median TTP is > 41 months versus 25.9 months for placebo. | 614 enrolled post-ASCT. 79%/21% had single or tandem ASCT. 80% completed 2 cycles. | | Goals: transplant vs. none; 10mg R maint vs. none. **Rd responses: CR 5%, VGPR 32%, PR 47%** | |

Source: Wells Fargo Securities, LLC and cited studies.

Note: $^{\$}$= median 9 months follow-up. After 6 cycles of MPR and tandem transplant a 2nd randomization for all patients will occur where patients will receive no maintenance or maintenance until relapse (consisting of **10mg Revlimid** d1-21).

**Pomalidomide Updated MM Results**

Early results with pomalidomide indicate that treatment following *Revlimid* and *Velcade*, respectively can result in patient responses. Pomalidomide is showing considerable promise, capable of restoring responsiveness despite exposure to prior bortezomib and lenalidomide, achieving a 30% RR in combination with dexamethasone in patients who failed *Revlimid*. Overall, the responses have been the highest ever seen in relapsed / refractory myeloma.

**Lymphoma – ASCO 2010**

Beyond myeloma, our attention remains on data that will have the greatest implications for future long-term growth, namely results from studies in NHL. Although there are 180k myeloma patients eligible for *Revlimid* in the U.S., E.U.-5 and Japan, there are 225k eligible follicular lymphoma patients and 260k eligible diffuse B-cell lymphoma patients.

Some clinicians believe the combination of *Revlimid*+Rituxan (R^2) could potentially supplant R-CHOP in the front-line treatment of some lymphomas. One prior FDA advisor has indicated expectations for *Revlimid* to emerge as front-runner in the treatment of indolent NHL. The R^2 combination continues to demonstrate incredibly impressive results. As ASH 2009, preliminary results for the Ph. II trial evaluating R^2 in the treatment of relapsed and refractory indolent non-Hodgkin's lymphoma were presented. This is the first trial to show that the R^2 combination has promising clinical activity in patients with relapsed/refractory disease. Despite 88% (14/16) of patients being Rituxan resistance, 75% of patients responded to the R2 combination with 31% of patients achieving a complete response (CR). This response is better than those achieved with Rituxan monotherapy in treatment naive patients. Even more impressive were the updated results from Folwer et al. which evaluated the combination in treatment naive indolent NHL. In patients with follicular lymphoma an incredible 94% (16/17) achieved complete responses (CRs), four of eight patients with marginal zone lymphoma achieved a CR, and one patient with small lymphocytic lymphoma achieved a CR. Together, the overall response rate across all 28 patients was 85% with 75% achieving CR. No patients experienced disease progression while on therapy. Responses to *Revlimid* appear to improve with continued treatment as higher CR rates correlate with a longer duration of therapy. Updated results form Fowler will emerge at ASCO 2010.

**Results from Combination of Lenalidomide and Rituximab for Front-Line Therapy of Indolent B-Cell Non-Hodgkin's Lymphoma**

| Histology | n | ORR % | Cr/Cru, n | PR, n | SD, n |
|---|---|---|---|---|---|
| Response By Histotology | | | | | |
| Follicular Lymphoma | 17 | **94%** | **94% (16/17)** | 0.0 | 6% (1) |
| Small Lymphocytic Lymphoma | 3 | **100%** | 33% (1) | 66% (2) | 0.0 |
| Marginal Zone Lymphoma | 8 | **63%** | 50% (4) | 13% (1) | 38% (3) |

Sourse: American Society of Hematology's 51st Annual Meeting and Wells Fargo Securities, LLC

***Revlimid* Expansion Humming**

Bucking the healthcare earnings trend, Celgene beat and raised guidance recently – driven by *Revlimid*. *Revlimid* sales reached $530 million, well above the consensus estimate of $497. This represents a 46% y/y growth. Importantly, share gains across major markets, global expansion and increasing durations remain the engines of growth. *Revlimid* median duration of use increased to 12.1 months up from 11.5 months in the U.S. Free goods declined slightly indicating an improving economy. In addition, total front-line share increased. In Europe, shares gains increased to 45% and duration trends are increasing.

In addition, Vidaza grew 60% y/y. Together, total revenues of $791 million exceed consensus of $758 million this contributed to Non-GAAP EPS of $0.63 compared to First Call Street consensus of $0.61. Non-GAAP diluted EPS increased 43% y/y.

Following a great quarter, management increased guidance. Total revenue are expected to increase ~25%y/y to a range of $3.3 to $3.4 billion, up from a previous range of $3.2 to $3.3 Billion. *Revlimid* net product sales are anticipated to increase ~30% y/y to a range of $2.2 to $2.3 billion, up from a previous range of $2.1 to $2.2 billion. Non-GAAP diluted earnings per share is expected to increase ~ 25% y/yr to a range of $2.60 to $2.65, up from a previous range of $2.55 to $2.60.

**Celgene's Upcoming Milestone Schedule**

| Timing | Event |
|---|---|
| 2010? | Initiate a Phase I trial with a sirtuin antagonist in oncology. |
| 2010? | Initiate amrubicin Phase II trials in adjuvant breast cancer in order to evaluate cardiotoxicity. |
| 2010 | Initiate a broad Phase II program for the placental stem-cells program (Crohn's, multiple sclerosis, and ulcerative colitis). |
| 2010 | Potential Compendia Listing for *Revlimid* for the treatment of aggressive NHL (post-publication of NHL-003). |
| 2010 | Conclude the Phase II study of pomalidomide in myelofibrosis. |
| 2010 | Initiate a Phase II study of apremilast in rheumatoid arthritis. |
| 2010 | Initiate Phase II trial for JNK CC-930 in idiopathic pulmonary firbrosis and discoid lupus erythematosus. |
| 2010 | Initiate a Phase I study of CC-223 (mTOR kinase inhibitor; TORKi) in solid tumors. |
| H1 2010 | Complete recruitment for the two Phase I/II oral azacitidine studies (U.S. 2007 CL005, n=120 and U.S. 2008 CL008, n=60). |
| H1 2010 | Eisai and J&J to conclude the *Dacogen* AML Phase III study. |
| H1 2010 | Commence a Phase III study of *Vidaza* in AML in 300 elderly patients. |
| Q2 - Mid 2010 | Top-level Phase II(b) PSOR-004 apremilast results (n=30) in recalcitrant psoriasis. |
| Q2 - Mid 2010 | Initiate a Phase III trial evaluating apremilast for moderate-to-severe psoriasis with a regulatory endpoint of PASI 75. |
| Q2 - Mid 2010 | Initiate a Phase III program for apremilast in psoriatic arthritis exploring 20mg b.i.d. and a 30mg b.i.d. dose (a dose being studied in the psoriasis PSOR-005 study) with a regulatory endpoint of ACR 20. |
| Q2 - Mid 2010 | Initiate Phase II/III randomized study of *Revlimid* in GCB versus non-GCB positive DLBCL patients (DCL-001). |
| Q2 - Mid 2010 | Initiate the Phase III IFM/DFCI study with consolidation of *Revlimid*, *Velcade*, and low-dose dexamethasone (RVd) in an ASCT setting followed by ASCT or RVd and then one year of maintenance *Revlimid*. |
| June 4-8, 2010 | ASCO: Oral presentation of *Revlimid* maintenance trials IFM 2005-02, MM-015 and CALGB 100104; Interim data from Phase II trial of Revlimid in GCB+ DLBCL; R2 regimen in follicular lymphoma, Rituxan follwed by Revlimid in CLL, |
| June 10-13, 2010 | European Hematology Association Meeting: present updated MM-015 data which includes 70% of the PFS events. |
| Mid 2010 | Pivotal Phase II results for *Istodax* in peripheral T-cell lymphoma (PTCL). |
| Mid 2010 | Complete enrollment of Phase II study of *Revlimid* in follicular (CALGB-50401) non-Hodgkin's lymphoma (NHL). |
| Q3 2010 | Report safety data for Phase II CLL study for *Revlimid* (CLL-001; n= 50). |
| H2 2010 | Japanese approval of *Revlimid* in MM. |
| H2 2010 | Secure Japanese reimbursement for *Revlimid* in MM and then subsequently launch it. |
| H2 2010 | Conclude enrollment in the MM-020, FIRST study comparing *Revlimid* + low-dose dexamethasone versus MPT (n=1,590). |
| H2 2010 | Commence Phase II proof of concept studies of JNK-930 in idiopathic pulmonary fibrosis and discoid lupus erythematosus. |
| H2 2010 | Initiate third and fourth Phase III studies for apremilast to support approval in psoriasis and psoriatic arthritis. |
| H2 2010 | Initiate a Phase III trial evaluating pomalidomide for myelofibrosis. |
| H2 2010 | Initiate a Phase III trial evaluating pomalidomide for myeloma. |
| H2 2010 | File for approval of *Revlimid* for front-line multiple myeloma, initially in Europe and then followed by the United States and other global markets. This is paced by feedback from regulators during 2010 and completion of data collection for the 70% of PFS events (ongoing during Q2 2010). |
| H2 2010 | Data from the Phase III trial evaluating amrubicin in the 2nd-line treatment of 620 small cell lung cancer patients. |
| H2 2010 | Japanese approval of *Revlimid* in MDS 5q-. |
| Q4 2010 | File for approval of *Istodax* in peripheral T-cell lymphoma. |
| Q4 2010 | Submit MDS-004 EU data to support an MAA or supplemental MAA in EU. |
| November 22, 2010 | Expiration of Celgene's 30-month stay against Teva/Barr's ANDA for thalidomide. |
| December 27, 2010 | Expiration of *Revlimid* Hatch-Waxman exlcusivity period. |
| End 2010 | Complete enrollment in the Phase II EMERGE (MCL-001) trial in relapsed/refractory MCL (United States registration |
| End 2010 | Complete enrollment in the Phase II SPRINT (MCL-002) study in relapsed/refractory MCL (EU registration study). |
| End 2010 | Continue enrolling the Phase III GELA sponsered trial evaluating *Revlimid* maintenance after R-CHOP in DLBCL. |
| End 2010 | Complete enrollment for *Revlimid* SPA Phase III CLL study, CONTINUUM (CLL-002), in maintenance CLL. |
| End 2010 | Complete enrollment of the *Revlimid* SPA Phase III CLL study, ORIGIN (CLL-008) in untreated elderly patients. |
| End 2010/early 2011 | Data from the Phase III trial evaluating *Revlimid* in smoldering myeloma (QUIREDEX, PETHEMA study). |
| ASH 2010 | Interim data from CALGB-50401 comparing *Revlimid* vs. *Rituxan* vs. *Revlimid* + *Rituxan* in lymphoma. |

Source: Company reports and Wells Fargo Securities, LLC estimates

**Celgene's Upcoming Milestone Schedule Continued**

| | |
|---|---|
| 2011 | File for United States and EU approvals of *Revlimid* for the treatment of relapsed/refractory MCL. |
| Mid 2011 | Report secondary efficacy endpoints data for CLL-008: overall survival, progression-free survival, objective response rate, duration of response, time to response, and minimal residual disease. |
| Mid 2011 | Approval of *Revlmid* in the maintenance setting in the U.S. and Europe. |
| H2 2011 | FDA approval of *Istodax* for the treatment of progressive or relapsed Peripheral T-cell Lymphoma (PTCL). |
| H2 2011 | Japanese approval of *Vidaza* in MDS. |
| H2 2011 | File for United States and EU approvals of *Revlimid* for the treatment of Smoldering myeloma. |
| Mid -2012 | FDA approval of *Revlimid* in relapsed/refractory MCL based on EMERGE (MCL-001). |
| Mid 2012 | Top-line initial results from the MM-020 FIRST study. |
| Mid 2012 | Approval of amrubicin for the treatment of small-cell lung cancer (SCLC). |
| H2 2012/ 2013 | Approval of *Apremilast* for the treatement of psoriasis. |
| H2 2012/ 2013 | Data from the Phase III MAINSAIL trial evaluating the efficacy and safety of docetaxel and prednisone with or without *Revlimid* in subjects with castrate-resistant prostate cancer. |
| H1 2013 | Approval of *Apremilast* for the treatement of psoriatic arthritis (PsA). |
| Mid 2013 | EMEA approval of Revlimid in relapsed/refractory MCL based on SPRINT (MCL-002). |
| H2 2013 | Approval of pomalidomide for the treatment of relapsed/refractory multiple myeloma. |
| H2 2013 | Approval of pomalidomide for the treatment of myelofibrosis based on the MF-002 results. |
| H1 2014 | Approval of *Revlimid* for untreated elderly CLL patients based on the ORIGIN (CLL-008) study. |
| Mid 2014 | Approval of *Revlimid* as a maintenance treatment of CLL based on the CONTINUUM (CLL-002) study. |
| Mid 2014 | Approval / label expansion of the *Revlimid* in the front-line setting based on the MM-020 results. |
| Mid 2014 | Approval of *Revlimid* maintenance/continuous dosing in mantle cell lymphoma based on results from RENEW (MCL-003). |
| Mid 2014 | Approval of Vidaza for the treatment of acute myelogenous leukemia (AML). |
| 2015 | Celgene Guidance of > $6 billion in hematology-oncology sales by 2015. |
| 2015 | Approval of *Revlimid* for the treatment of low-risk/intermediate 1non-del5q myelodysplastic syndrome (MDS) patients. |
| 2015 | Approval of *Revlimid* in subjects with castrate-resistant prostate cancer. |
| H2 2015 | Approval of *Revlimid* for the treatment of relapsed or refractory B-Cell Lymphoma (DBCL) based on the DLC-001 trial. |
| 2016 | Results of the Phase III GELA sponsered trial evaluating Revlimid maintenance after R-CHOP in DLBCL. |

Source: Company reports and Wells Fargo Securities, LLC estimates

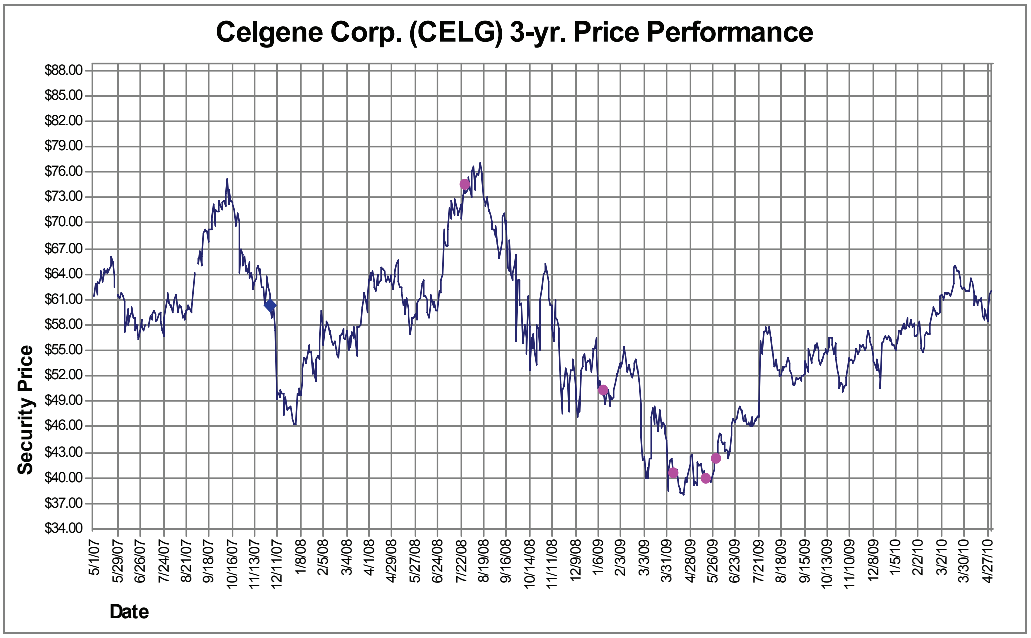
## Celgene's Income Statement

**Celgene**
**Income Statement**
All figures in millions, except per share amounts
FY ends December 31

| | 2009A | 2010E Q1:10A | 2010E Q2:10E | 2010E Q3:10E | 2010E Q4:10E | 2010E | 2011E | 2012E | 2013E | 2014E | 2015E |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Revenue** | | | | | | | | | | | |
| Revlimid | 1,706.4 | 530.5 | 555.2 | 606.8 | 641.1 | 2,333.7 | 2,915.8 | 3,511.5 | 3,767.9 | 4,294.0 | 4,912.0 |
| Vidaza (w.w.) | 387.4 | 120.3 | 131.0 | 136.0 | 139.2 | 526.5 | 654.5 | 571.6 | 652.3 | 710.0 | 749.0 |
| Thalomid (w.w) | 437.2 | 104.0 | 103.8 | 103.6 | 103.2 | 414.6 | 407.0 | 340.7 | 358.5 | 399.9 | 445.6 |
| Istodax | - | - | 3.0 | 6.5 | 9.5 | 19.0 | 64.0 | 104.0 | 130.0 | 162.5 | 203.1 |
| Amrubicin | - | - | - | - | - | - | 59.5 | 119.0 | 148.8 | 186.0 | 232.5 |
| Alkeran | 19.9 | - | - | - | - | - | - | - | - | - | - |
| Focalin | 4.9 | 1.2 | 1.0 | 1.0 | 1.0 | 4.2 | 6.5 | 7.0 | 7.0 | 7.0 | 7.0 |
| Other | 11.4 | 3.4 | 1.0 | 1.0 | 1.0 | 6.4 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 |
| **Total Net Product Sales** | **2,567.3** | **759.4** | **795.1** | **854.9** | **895.0** | **3,304.4** | **4,108.8** | **4,655.3** | **5,066.0** | **5,760.9** | **6,550.7** |
| % Change Yr/Yr | 20% | 32% | 33% | 28% | 23% | 29% | 24% | 13% | 9% | 14% | 14% |
| % Change Qtr/Qtr | N/A | 5% | 5% | 8% | 5% | N/A | N/A | N/A | N/A | N/A | N/A |
| Collaborative Agreements & Other Revenue | 13.7 | 2.4 | 2.4 | 2.4 | 2.4 | 9.6 | 15.0 | 15.0 | 15.0 | 15.0 | 15.0 |
| Royalty Revenue | 108.8 | 29.5 | 28.0 | 28.0 | 28.0 | 113.5 | 90.0 | 95.0 | 95.0 | 95.0 | 95.0 |
| **Total Revenue** | **2,689.8** | **791.3** | **825.5** | **885.4** | **925.4** | **3,427.5** | **4,213.8** | **4,765.3** | **5,176.0** | **5,870.9** | **6,660.7** |
| **Operating Expenses** | | | | | | | | | | | |
| Cost of Goods Sold | 219.6 | 61.9 | 57.8 | 62.0 | 64.8 | 246.5 | 295.0 | 338.3 | 372.7 | 428.6 | 492.9 |
| Gross Margin | 2,470.2 | 729.3 | 767.7 | 823.4 | 860.6 | 3,181.1 | 3,918.8 | 4,427.0 | 4,803.3 | 5,442.4 | 6,167.8 |
| Gross Margin (%) | 92% | 93% | 93% | 93% | 93% | 93% | 93% | 93% | 93% | 93% | 93% |
| Research & Development | 794.8 | 204.7 | 243.5 | 261.2 | 273.0 | 982.3 | 1,191.5 | 1,256.9 | 1,317.2 | 1,423.0 | 1,473.9 |
| SG&A | 753.8 | 208.0 | 194.0 | 216.9 | 231.3 | 850.2 | 891.6 | 935.7 | 977.7 | 1,060.0 | 1,126.7 |
| Acquired IPR&D, Amortization (other) | 83.4 | 46.5 | 15.0 | 15.0 | 15.0 | 91.5 | 50.0 | 30.0 | 30.0 | 30.0 | 30.0 |
| Total Operating Expenses | 1,848.4 | 521.0 | 510.3 | 555.1 | 584.1 | 2,170.5 | 2,428.1 | 2,561.0 | 2,697.6 | 2,941.5 | 3,123.5 |
| **Operating Income** | **$841.5** | **$270.3** | **$315.2** | **$330.3** | **$341.3** | **$1,257.0** | **$1,785.7** | **$2,204.3** | **$2,478.4** | **$2,929.4** | **$3,537.2** |
| Interest and Other Income, net | 134.2 | 18.1 | 17.1 | 18.7 | 20.4 | 74.4 | 104.8 | 142.6 | 189.8 | 245.2 | 311.9 |
| Income Before Taxes | 975.7 | $288.4 | $332.3 | $349.0 | $361.7 | $1,331.4 | $1,890.5 | $2,346.9 | $2,668.2 | $3,174.5 | $3,849.0 |
| Income Tax Expense/(Benefit) | 199.0 | 53.9 | 62.1 | 65.3 | 67.6 | 248.9 | 378.1 | 469.4 | 520.3 | 603.2 | 731.3 |
| Rate (%) | 21% | 19% | 19% | 19% | 19% | 19% | 20% | 20% | 20% | 19% | 19% |
| GAAP Net Income (loss) | $776.7 | $234.5 | 270.2 | $283.8 | $294.1 | $1,082.5 | $1,512.4 | $1,877.5 | $2,147.9 | $2,571.4 | $3,117.7 |
| Basic EPS | $1.69 | $0.51 | $0.59 | $0.62 | $0.64 | $2.35 | $3.27 | $4.04 | $4.60 | $5.49 | $6.62 |
| Diluted EPS | $1.66 | $0.50 | $0.58 | $0.61 | $0.63 | $2.32 | $3.21 | $3.96 | $4.51 | $5.37 | $6.49 |
| **Adjusted (Non-GAAP) Net Income** | **$971.1** | **$294.6** | **$305.2** | **$313.8** | **$329.1** | **$1,242.6** | **$1,642.4** | **$2,007.5** | **$2,332.9** | **$2,746.4** | **$3,292.7** |
| Basic EPS | $2.11 | $0.64 | $0.66 | $0.68 | $0.71 | $2.70 | $3.55 | $4.32 | $5.00 | $5.86 | $7.00 |
| **Diluted EPS** | **$2.08** | **$0.63** | **$0.65** | **$0.67** | **$0.70** | **$2.66** | **$3.49** | **$4.23** | **$4.89** | **$5.74** | **$6.85** |
| Basic Shares | 459.3 | 459.9 | 460.4 | 460.9 | 461.4 | 460.7 | 462.7 | 464.7 | 466.7 | 468.7 | 470.7 |
| Diluted Shares | 467.3 | 467.7 | 467.4 | 467.4 | 467.7 | 467.5 | 470.7 | 474.7 | 476.7 | 478.7 | 480.7 |

Source: Company reports and Wells Fargo Securities, LLC estimates

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 12/3/2007 | | Reames | | | |
| ◆ | 12/3/2007 | 60.28 | 1 | 81.00 | 93.00 | 60.28 |
| ● | 7/25/2008 | 74.27 | 1 | 84.00 | 93.00 | 74.54 |
| ● | 1/13/2009 | 50.36 | 1 | 80.00 | 89.00 | 50.36 |
| ● | 4/7/2009 | 40.48 | 1 | 76.00 | 84.00 | 40.48 |
| ● | 5/18/2009 | 39.79 | 1 | 71.00 | 82.00 | 39.98 |
| ● | 5/29/2009 | 41.77 | 1 | 74.00 | 82.00 | 42.24 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- ❐ Split Adjustment

**Rating Code Key**
- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

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- Wells Fargo Securities, LLC or its affiliates intends to seek or expects to receive compensation for investment banking services in the next three months from Celgene Corp.

**CELG:** Celgene faces a Teva thalidomide ANDA challenge and Revlimid competitive pressures.

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As of: May 7, 2010

| | |
|---|---|
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SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE

May 7, 2010

WELLS FARGO SECURITIES

# *Equity Research*

## CGI Group, Inc.

**GIB: Announces Acquisition of Stanley (SXE) Increases Presence Within U.S. Federal Market**

**Outperform / V**

Sector: Global Service Providers
Market Weight

***Company Note***

- Summary. This morning GIB announced it has entered into a definitive agreement to acquire U.S. Federal Services Provider Stanley (SXE) for $1.07bn (CY11: 16.7x EPS, 9.7x EBITDA). Stanley is one of the most well regarded and fastest growing public companies in the U.S. Federal space. A deal of this nature fits the strategic priorities of GIB's build and buy growth strategy focusing on the U.S. and Western Europe as well as its financial hurdle of being GAAP accretive within the first twelve months (which we do not see being a stretch). We believe the patience management has demonstrated with M&A (last acquisition being AMS in 2004) and the addition of a quality asset in Stanley should ease investors' concerns over the company's build and buy strategy. We have provided Wells Fargo Securities, LLC's SXE model for your convenience (Edward Caso Senior Analyst).
- Terms of the Deal / Funding. GIB has agreed to pay $1.07bn in cash or $37.50 per SXE share. The deal is expected to close by Fall 2010. Break-up fee of $28mm is payable to GIB under customary circumstances. GIB expects to use cash on hand and draw upon its $1.5bn credit facility (Libor +60bps) to fund the acquisition. Post the acquisition the company expects to have a net debt to capitalization ratio between 20-30%, and net debt to EBITDA of 1.1-1.4x which is still within a comfortable range given its strong cash flow. The company will have $600mm of remaining liquidity after the deal.
- Valuation. Based on Wells Fargo Securities, LLC estimates for SXE the transaction is valued at 16.7x CY11 EPS and 9.7x EV/EBITDA. Based on Thursday's close the P/E and EV/EBITDA ranges are 11-15x and 5.5-7.8x, respectively. Stanley's higher growth and margins compared to the group justify the premium, in our view.
- What Stanley Gives CGI. A much larger presence within the U.S. Federal space as combined revenue post the deal is expected to be ~$1.2bn up from $350mm in CY09. An entrance into the Defense and Intelligence side of the Federal market (pre deal Defense & Intel was 1% of Federal rev; Post deal expected to be 55%). Areas of strength for Stanley include systems engineering, Business Process Outsourcing, Biometrics/Cyber security, among others. Post the deal overall revenue from the U.S. is expected to be ~46% up from 33% today.

| | 2009A | 2010E | | 2011E | |
|---|---|---|---|---|---|
| **EPS** | | **Curr.** | **Prior** | **Curr.** | **Prior** |
| **Q1** (Dec.) | $0.21 | $0.25 A | NC | $0.30 | NC |
| **Q2** (Mar.) | 0.21 | 0.28 A | NC | 0.31 | NC |
| **Q3** (June) | 0.23 | 0.29 | NC | 0.32 | NC |
| **Q4** (Sep.) | 0.25 | 0.30 | NC | 0.33 | NC |
| **FY** | $0.91 | $1.12 | NC | $1.27 | NC |
| **CY** | $0.94 | $1.16 | | $1.31 | |
| **FY P/E** | 15.7x | 12.8x | | 11.3x | |
| **Rev.(MM)** | $3,425 | $3,658 | | $3,880 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

| | |
|---|---|
| Ticker | GIB |
| Price (05/07/2010) | $14.32 |
| 52-Week Range: | $8-16 |
| Shares Outstanding: (MM) | 292.2 |
| Market Cap.: (MM) | $4,184.3 |
| S&P 500: | 1,120.79 |
| Avg. Daily Vol.: | 190,437 |
| Dividend/Yield: | $0.00/0.0% |
| LT Debt: (MM) | $423.4 |
| LT Debt/Total Cap.: | 18.4% |
| ROE: | 14.0% |
| 3-5 Yr. Est. Growth Rate: | 12.0% |
| CY 2010 Est. P/E-to-Growth: | 1.0x |
| Last Reporting Date: | 04/28/2010 |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

**Valuation Range: $17.00 to $18.00**
Our valuation range is based on 13.0x-14.0x our CY2011 EPS estimate. Risks to our valuation range include a weak economy, revenue concentration with BCE, acquisition integration.

**Investment Thesis:**
We view GIB as a well managed Canadian based IT services provider that is still largely unknown to U.S. investors. We believe the shares are attractive at the current valuation due to the expectation of constant currency revenue growth acceleration and operating margin expansion. We also believe the company's valuation should benefit by being one of the few remaining independent North American IT services providers.

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**Please see page 6 for rating definitions, important disclosures and required analyst certifications**

## Company Description:

CGI Group Inc. (NYSE: GIB, TSX: GIB.A) is the leading Canadian based global information technology and business process outsourcing services firm that is increasingly expanding its presence in the United States and Europe.

**CGI Group Inc.**
**Annual Earnings Model**

(in CDN $ thousands, except per share amounts)

| | FY2008 (Sep) | FY2009 (Sep) | FY2010E (Sep) | FY2011E (Sep) | CY2009 (Dec) | CY2010E (Dec) | CY2011E (Dec) |
|---|---|---|---|---|---|---|---|
| **Net revenue** | **$3,705,863** | **$3,825,161** | **$3,703,447** | **$3,880,000** | **$3,737,795** | **$3,740,441** | **$3,940,000** |
| Operating expenses | 3,110,520 | 3,170,406 | 3,020,025 | 3,165,965 | 3,083,714 | 3,047,690 | 3,212,075 |
| EBITA | **595,343** | **654,755** | **683,422** | **714,035** | **654,081** | **692,751** | **727,925** |
| Amortization | 163,944 | 195,761 | 188,320 | 192,085 | 194,584 | 190,564 | 197,045 |
| Non recurring expense (income) | 1,445 | - | - | - | - | - | - |
| **Operating income** | 429,954 | 458,994 | 495,102 | 521,950 | 459,497 | 502,187 | 530,880 |
| Net interest expense (income) | 25,055 | 20,956 | 12,370 | 9,200 | 15,107 | 11,612 | 8,800 |
| Other expense (income) | - | (2,809) | (1,817) | - | (7,472) | (168) | - |
| Pretax income | 404,899 | 440,847 | 484,549 | 512,750 | 451,862 | 490,743 | 522,080 |
| Income tax expense | 106,133 | 125,446 | 121,264 | 158,953 | 104,739 | 153,945 | 161,845 |
| Other/Cumulative effect of accounting ch | 868 | 238 | - | - | 238 | - | - |
| **Net income continuing ops** | 297,898 | 315,163 | 363,285 | 353,798 | 346,885 | 336,798 | 360,235 |
| Nonrecurring items (net of tax) | (5,134) | - | (30,500) | - | (30,500) | - | - |
| Pro forma Net Income | 292,764 | 315,163 | 332,785 | 353,798 | 316,385 | 336,798 | 360,235 |
| EPS (reported) | $0.91 | **$1.02** | $1.23 | **$1.27** | $1.13 | **$1.16** | **$1.31** |
| EPS (pro forma) | **$0.92** | $1.02 | **$1.13** | $1.27 | **$1.03** | $1.16 | $1.31 |
| Avg. no. of diluted shares | 322,804 | 310,197 | 294,556 | 279,339 | 308,022 | 290,339 | 275,839 |
| **U.S. $ denominated** | | | | | | | |
| Revenue (U.S. $) | $3,740,250 | $3,425,086 | $3,657,797 | $3,880,000 | $3,493,942 | $3,740,441 | $3,940,000 |
| EPS (U.S. $) reported | 0.93 | $0.91 | $1.12 | $1.27 | $0.94 | $1.16 | $1.31 |
| Using the exchange rate $1.00 per C$1 for estimates | | | | | | | |
| **Yr/yr % increase:** | | | | | | | |
| Net revenue | 2% | 3% | (3%) | 5% | (2.4%) | 0% | 5% |
| organic growth | | | | | | | |
| constant currency | 5% | (2%) | | | | | |
| EBITA | 3 | 10 | 4 | 4 | 7 | 6 | 5 |
| EPS (pro forma) | 23 | 10 | 11 | 12 | 12 | 13 | 13 |
| Avg. no. of diluted shares | (3) | (4) | (5) | (5) | (3) | (6) | (5) |
| Operating expenses | 83.9% | 82.9% | 81.5% | 81.6% | 82.5% | 81.5% | 81.5% |
| EBITA margin (net) | 16.1 | 17.1 | 18.5 | 18.4 | 17.5 | 18.5 | 18.5 |
| Amortization | 4.4 | 5.1 | 5.1 | 5.0 | 5.2 | 5.1 | 5.0 |
| **Operating margin (net)** | **11.6** | **12.0** | **13.4** | **13.5** | **12.3** | **13.4** | **13.5** |
| Adjusted Operating margin (net) | | 12.3 | | | | | |
| Pretax margin (net) | 10.9 | 11.5 | 13.1 | 13.2 | 12.1 | 13.1 | 13.3 |
| Tax rate | 26.2 | 28.5 | 25.0 | 31.0 | 23.2 | 31.4 | 31.0 |

Source: Company data and Wells Fargo Securities, LLC estimates

**Stanley, Inc.**
**Annual Earnings Statement, (March) FY2006-12E and CY2009-11E**
($ in thousands, except per share data)

PEO-STRI $40mm FY11 growover, or about 5 pts

| | FY2006 | FY2007 | FY2008 | FY2009 | FY2010E | FY2011E | FY2012E | CY2009 | CY2010E | CY2011E |
|---|---|---|---|---|---|---|---|---|---|---|
| | (Mar 06) | (Mar 07) | (Mar 08) | (Mar 09) | (Mar 10) | (Mar 11) | (Mar 11) | | | |
| | | | | Guidance: | $868-876mm | | | | | |
| **Revenue** | **$284,801** | **$409,411** | **$604,342** | **$779,678** | **$873,858** | **$950,000** | **$1,065,000** | **$865,295** | **$916,000** | **$1,040,000** |
| Cost of revenue | 248,260 | 349,647 | 512,250 | 653,673 | 728,241 | 793,350 | 890,375 | 721,824 | 764,229 | 869,450 |
| Gross Profit | 36,541 | 59,764 | 92,092 | 126,005 | 145,617 | 156,650 | 174,625 | 143,471 | 151,771 | 170,550 |
| Selling, general & administrative | 12,806 | 24,686 | 37,236 | 49,114 | 55,431 | 58,535 | 64,610 | 54,298 | 57,634 | 63,415 |
| **EBITDA** | **23,735** | **35,078** | **54,856** | **76,891** | **90,186** | **98,115** | **110,015** | **89,173** | **94,137** | **107,135** |
| Amortization of deferred compensation | 790 | 954 | 266 | 248 | 0 | 0 | 0 | 62 | 0 | 0 |
| Depreciation & Amortization | 3,057 | 5,418 | 6,695 | 9,988 | 11,477 | 11,900 | 12,500 | 11,521 | 11,800 | 12,300 |
| Other | 3,590 | 4,129 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **Operating income** | **16,298** | **24,577** | **47,895** | **66,655** | **78,709** | **86,215** | **97,515** | **77,590** | **82,337** | **94,835** |
| Net Interest income (expense) | (2,441) | (5,914) | (3,778) | (5,396) | (3,744) | (3,250) | (2,850) | (4,125) | (3,350) | (2,950) |
| Other income | 101 | (481) | 19 | 26 | 3 | 0 | 0 | 9 | 0 | 0 |
| Pretax income | 13,958 | 18,182 | 44,136 | 61,285 | 74,968 | 82,965 | 94,665 | 73,474 | 78,987 | 91,885 |
| Income tax expense | 5,708 | 7,477 | 17,972 | 24,054 | 29,380 | 32,771 | 37,393 | 28,713 | 31,219 | 36,295 |
| **Net income** | **8,250** | **10,705** | **26,164** | **37,231** | **45,588** | **50,194** | **57,272** | **44,761** | **47,768** | **55,590** |
| EPS (pro forma) | $0.74 | $0.68 | $1.12 | $1.56 | $1.90 | $2.05 | $2.30 | $1.87 | $1.96 | $2.05 |
| **EPS (GAAP, diluted)** | **0.51** | **0.55** | **1.12** | **1.56** | **1.90** | **2.05** | **2.30** | **1.87** | **1.96** | **2.25** |
| | | | | Guidance (GAAP): | $1.87-1.89 | | | | | |
| Avg. no. of shares--diluted | 16,096 | 19,500 | 23,414 | 23,814 | 24,047 | 24,450 | 24,850 | 23,953 | 24,350 | 24,750 |
| **Yr/Yr % increase:** | | | | | | | | | | |
| **Revenue** | **1%** | **44%** | **48%** | **29%** | **12%** | **9%** | **12%** | **17%** | **6%** | **14%** |
| *Organic growth* | *NA* | *18%* | *37%* | *19%* | *8%* | *9%* | *11%* | *NA* | *NA* | *NA* |
| EBITDA | 8 | 48 | 56 | 40 | 17 | 9 | 12 | 25 | 6 | 14 |
| Operating income | (15) | 51 | 95 | 39 | 18 | 10 | 13 | 25 | 6 | 15 |
| Avg. no. of diluted shares | (0) | 21 | 20 | 2 | 1 | 2 | 2 | 1 | 2 | 2 |
| Gross Margin | 12.8% | 14.6% | 15.2% | 16.2% | 16.7% | 16.5% | 16.4% | 16.6% | 16.6% | 16.4% |
| SG&A expense/revenue | 4.5 | 6.0 | 6.2 | 6.3 | 6.3 | 6.2 | 6.1 | 6.3 | 6.3 | 6.1 |
| **EBITDA margin** | **8.3** | **8.6** | **9.1** | **9.9** | **10.3** | **10.3** | **10.3** | **10.3** | **10.0** | **10.3** |
| D&A/revenue | 1.1 | 1.3 | 1.1 | 1.3 | 1.3 | 1.3 | 1.2 | 1.3 | 1.3 | 1.2 |
| **Operating margin** | **5.7** | **6.0** | **7.9** | **8.5** | **9.0** | **9.1** | **9.2** | **9.0** | **9.0** | **9.1** |
| Pretax margin | 4.9 | 4.4 | 7.3 | 7.9 | 8.6 | 8.7 | 8.9 | 8.5 | 8.6 | 8.8 |
| Tax rate | 40.9 | 41.1 | 40.7 | 39.2 | 39.2 | 39.5 | 39.5 | 39.1 | 39.5 | 39.5 |

Source: Company data and Wells Fargo Securities LLC estimates

**Stanley, Inc.**
**Annual Balance Sheet - FY (March)**
($ in thousands)

| | FY2006 | FY2007 | FY2008 | FY2009 |
|---|---|---|---|---|
| Cash and equivalents | $0 | $12,736 | $271 | $1,811 |
| Accounts receivable, net (x-unbilled) | 57,674 | 73,067 | 120,504 | 121,185 |
| Unbilled revenue | 24,874 | 36,962 | 40,424 | 66,495 |
| Prepaid expenses and other | 2,196 | 1,631 | 4,644 | 6,766 |
| Total current assets | 84,744 | 124,396 | 165,843 | 196,257 |
| | | | | |
| PP&E | 10,083 | 11,736 | 12,894 | 19,552 |
| Goodwill | 87,832 | 88,249 | 113,615 | 262,705 |
| Intangibles | 12,616 | 9,417 | 8,088 | 15,557 |
| Other | 5,444 | 4,177 | 5,615 | 7,481 |
| Total assets | 200,719 | 237,975 | 306,055 | 501,552 |
| | | | | |
| Line of credit | 10,409 | - | - | - |
| Current portion of long-term debt | 1,000 | 1,000 | 1,000 | 1,000 |
| Acounts payable | 17,193 | 24,476 | 29,628 | 21,528 |
| Accrued expenses | 24,907 | 34,438 | 62,649 | 79,841 |
| Deferred income taxes | 1,225 | 2,646 | - | - |
| Income taxes payable | 711 | 917 | 5,836 | 2,034 |
| Total current liabilities | 55,445 | 63,477 | 99,113 | 104,403 |
| | | | | |
| Long-term debt, less current portion | 99,000 | 36,750 | 35,500 | 169,530 |
| Other long-term liabilities | 3,514 | 3,596 | 4,738 | 10,396 |
| Deferred income taxes | 371 | - | - | - |
| | | | | |
| Stockholders' equity | 42,389 | 134,152 | 166,704 | 217,223 |
| Total liabilities & stk. eq. | 200,719 | 237,975 | 306,055 | 501,552 |
| | | | | |
| Total cash | 0 | 12,736 | 271 | 1,811 |
| Total debt | 110,409 | 37,750 | 36,500 | 170,530 |
| Net cash | (110,409) | (25,014) | (36,229) | (168,719) |
| Total debt/(tot. debt + eq.) | 72% | 22% | 18% | 44% |
| | 4.7x | 0.7x | 0.7x | 2.2x |

Source: Company data

**Stanley, Inc.**
**Statement of Cash Flows - FY (March)**
($ in thousands, except per share data)

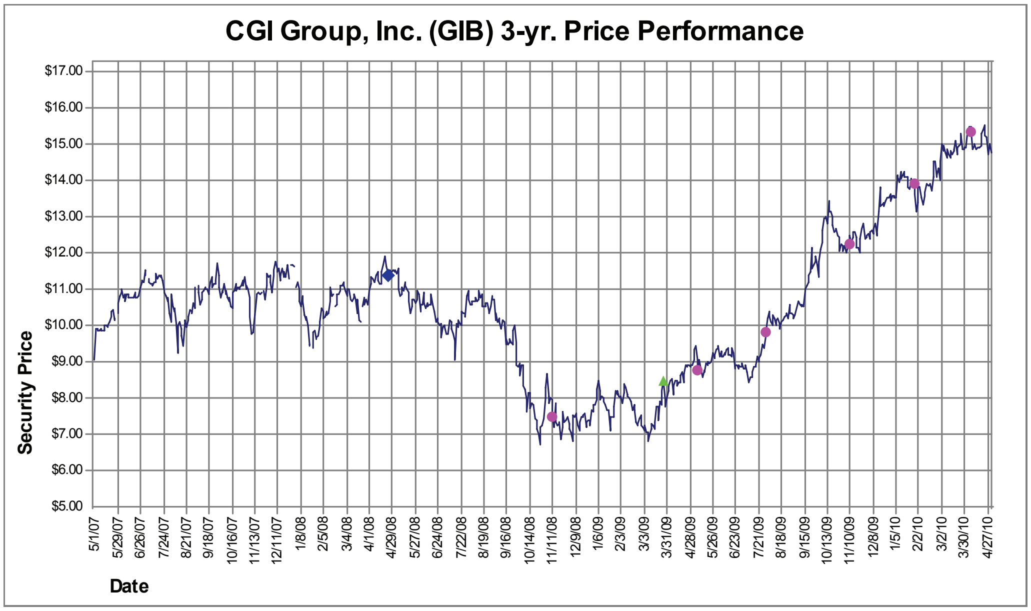
| | FY2006 | FY2007 | FY2008 | FY2009 |
|---|---|---|---|---|
| **Operating** | | | | |
| Net Income | $8,250 | $10,705 | $26,164 | $37,230 |
| Depreciation & Amortization | 3,057 | 5,424 | 6,695 | 9,988 |
| Other income statement items | 4,184 | 6,884 | 563 | 7,853 |
| Chg in accounts receivable | (9,100) | (28,297) | (46,095) | (5,166) |
| Net chge in other operating assets & liabs. | 3,833 | 21,321 | 33,738 | (5,358) |
| Net Cash Flow - Operating | 10,224 | 16,037 | 21,065 | 44,547 |
| **Investing** | | | | |
| Capital Expenditures | (5,472) | (3,865) | (3,844) | (8,774) |
| Acquisitions & Investments | (81,116) | (417) | (30,563) | (170,808) |
| Other Investing Activities | - | - | - | - |
| Net Cash Flow - Investing | (86,588) | (4,282) | (34,407) | (179,582) |
| **Financing** | | | | |
| Change in Current Debt | (10,805) | (10,409) | - | 135,030 |
| Change in Long-Term Debt | 91,081 | (62,379) | (1,422) | (1,270) |
| Change in Capital Stock | (3,912) | 73,769 | 2,203 | 2,258 |
| Other Financing Activity | - | - | 96 | 557 |
| Net Cash Flow - Financing | 76,364 | 981 | 877 | 136,575 |
| Increase (Dec) in Cash & ST Investments | - | 12,736 | (12,465) | 1,540 |
| **EBITDA** | **23,735** | **35,078** | **54,856** | **76,891** |
| **Free cash flow (a)** | **4,752** | **12,172** | **17,221** | **35,773** |

(a) Funds from operations less net purchases of PP&E.

| | | | | |
|---|---|---|---|---|
| OCF/NI | 1.2x | 1.5x | 0.8x | 1.2x |
| FCF/NI | 0.6x | 1.1x | 0.7x | 1.0x |

Source: Company data

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 4/24/2008 | | Boyer | | | |
| ◆ | 4/24/2008 | 11.37 | 2 | 11.00 | 12.00 | 11.37 |
| ● | 11/11/2008 | 7.95 | 2 | 9.00 | 10.00 | 7.49 |
| ▲ ● | 3/26/2009 | 8.21 | 1 | 9.50 | 10.50 | 8.49 |
| ● | 5/7/2009 | 9.06 | 1 | 11.00 | 12.00 | 8.77 |
| ● | 7/30/2009 | 9.72 | 1 | 12.00 | 13.00 | 9.83 |
| ● | 11/9/2009 | 12.30 | 1 | 14.00 | 16.00 | 12.24 |
| ● | 1/27/2010 | 13.89 | 1 | 16.00 | 17.00 | 13.89 |
| ● | 4/7/2010 | 15.50 | 1 | 17.00 | 18.00 | 15.36 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**

- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- □ Split Adjustment

**Rating Code Key**

| | | | |
|---|---|---|---|
| 1 | Outperform/Buy | SR | Suspended |
| 2 | Market Perform/Hold | NR | Not Rated |
| 3 | Underperform/Sell | NE | No Estimate |

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As of: May 7, 2010

| | |
|---|---|
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May 7, 2010

***Equity Research***

WELLS FARGO SECURITIES

# Data Networking Weekly Preview

**Cisco Earnings; Citrix Analyst Day**

Communication Technology

- **Cisco FQ3 2010 results (5/12).** We expect Cisco to report FQ3 2010 results on Wednesday May 12. We expect Cisco to at least meet our FQ3 2010 sales and non-GAAP EPS estimates of $10.33B and $0.39. Our estimates are above consensus of $10.22B and $0.38 and guidance looking for sales of $10.04-10.28B (+23-26%). Our FQ3 2010 estimates embed gross margin of 65.2% and opex at 36.9% of sales, in line with guidance of 64-65% and 36.5-37%. We believe Cisco benefited from the improved enterprise spending environment, with data center projects a key growth driver. For FQ4 2010, we model sales and non-GAAP EPS of $11.03B and $0.42, above consensus of $10.6B and $0.40. Our FQ4 2010 estimates embed $217MM in sales from Tandberg. We expect management to guide FQ4 2010 sales up 5-7% qtr/qtr and 27-29% yr/yr, gross margin in 64-65% range, and opex of 36.5-37.5% of sales.
- **Citrix Analyst Day (5/12).** We expect Citrix to hold Citrix Synergy 2010's Financial Analyst Track on Wednesday, May 12. The agenda includes Financial and Operating plans as well as Citrix Online, Desktop, and Datacenter & Cloud strategy sessions. Citrix recently reported CQ1 2010 results including sales of $414MM (-8.2% qtr/qtr, +12% yr/yr), exceeding consensus of $408.3MM and management guidance looking for $405-410MM. Additionally, management guided for CQ2 2010 sales of $430-440MM (+3.9 - 6.3% qtr/qtr). Citrix competes in the ADC and WAN Optimization markets. We believe the company's Financial Analyst Track may provide read-through for Cisco, F5, Riverbed, and BlueCoat.

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**Weekly Calendar--May 10-14, 2010**

May 2010

| Sunday | Monday | Tuesday | Wednesday | Thursday | Friday | Saturday |
|---|---|---|---|---|---|---|
| 9 | 10 | 11 | 12 Citrix Synergy 2010 Financial Analyst Track 6:00pm<br>Earnings Calls 4:30pm: CSCO | 13 | 14 | 15 |

Source: Company reports.

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May 7, 2010

WELLS FARGO SECURITIES

*Equity Research*

# DCT Industrial Trust Inc.

**DCT: Q1 Results Below Expectations--Maintains Guidance**

**Underperform / V**

Sector: Industrial
Market Weight

- **Summary:** DCT reported Q1 2010 FFO of $0.10 per share, $0.01 below our estimate and consensus. Rents were in line, but higher operating expenses and a $1.0MM (<$0.005 per share) caused the miss. FAD (FFO less capex and straight-line rent) was $0.08 per share, which was in line with our estimate despite lower FFO owing to lower than expected capex costs. We plan to revisit our estimates and valuation range after the conference call today (5/7).
- **Leasing/Operations:** Occupancy declined 230bps to 85.3%. A sizable drop in Q1 was expected, but the range previously discussed by management was 100-200bps. Leasing volume was decent however (3.2MMsq.ft.), particularly for Q1, which tends to be seasonally slow. Releasing spreads remained weak at -8.8% cash. The renewal rate of 65% was down from recent trend. Same-store NOI was -13.7% cash, dropping from -8.3% in Q4. We look for same-store to improve during the year as occupancy steadies. Capex costs were steady at $0.36/sq.ft./yr, consistent with recent results. The leased rate on the development pipeline improved from 21% to 34%--now at the top-end of the year guidance of 30-35%. Projected yields on the pipeline declined 10bps to 5.9%.
- **Investment Activity:** DCT previously anounced the implementation of a 20MM share continuous equity offering program (about $100MM at current share price) of which $9MM was raised to date. Proceeds were used to acquire a 150,000sq.ft. bulk distribution asset in New Jersey for $9.5MM; this is not included in 2010 guidance. This acquisition was previously announced and we estimated that the purchase would be $500,000-600,000 accretive to 2010 FFO.
- **Guidance:** Management tightened each end of its 2010 FFO guidance range by $0.01 to $0.37-0.43. Both our estimate and consensus are $0.42 per share. Guidance includes average occupancy of 84-89% and same-store NOI decline of down 6-8%. Q1 occupancy is 85.3% and same-store NOI was -11.5% (GAAP)--Q1 metrics and the lack of revision of guidance suggest that management remains confident that Q1 2010 should be at or near the trough. Guidance also contemplates the refinancing of $500MM in debt, of which $215MM was completed in Q1. DCT has also agreed to terms with its lenders for senior notes totaling $210MM in a private placement offering in April.
- Conference call is today (5/7) at 11am ET, #800-860-2442. Overall core metrics appeared a bit weaker than our expectations, but solid leasing volume and maintaining guidance suggest that improvement may be forthcoming. We'll look for additional color on the core outlook as well as potential for capital recycling.

***Earnings Reported - First Look***

| FFO | 2009A | 2010E Curr. | 2010E Prior | 2011E Curr. | 2011E Prior |
|---|---|---|---|---|---|
| **Q1** (Mar.) | $0.16 | **$0.10 A** | **0.11** | $0.10 | NC |
| **Q2** (June) | 0.12 | 0.11 | NC | 0.10 | NC |
| **Q3** (Sep.) | 0.11 | 0.10 | NC | 0.10 | NC |
| **Q4** (Dec.) | 0.11 | 0.10 | NC | 0.10 | NC |
| **FY** | $0.50 | $0.42 | NC | $0.41 | NC |
| **CY** | $0.50 | $0.42 | | $0.41 | |
| **FY P/FFO** | 10.4x | 12.4x | | 12.7x | |
| **Rev.(MM)** | $245 | $241 | | $250 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

| | |
|---|---|
| Ticker | DCT |
| Price (05/06/2010) | $5.20 |
| 52-Week Range: | $3-6 |
| Shares Outstanding: (MM) | 237.5 |
| Market Cap.: (MM) | $1,234.9 |
| S&P 500: | 1,128.15 |
| Avg. Daily Vol.: | 2,220,790 |
| Dividend/Yield: | $0.28/5.4% |
| LT Debt: (MM) | $1,130.9 |
| LT Debt/Total Cap.: | 51.7% |
| ROE: | 8.0% |
| 3-5 Yr. Est. Growth Rate: | 7.0% |
| CY 2010 Est. P/FFO-to-Growth: | 1.8x |
| Last Reporting Date: | 05/06/2010 After Close |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

**Valuation Range: $4.00 to $4.50**
High and low-ends based on 5% premium/discount to NAVe. Risks include acquisition timing/velocity and lease-up of domestic and international development projects.

**Investment Thesis:**
DCT owns a high-quality portfolio of industrial assets throughout the U.S., though the embedded growth in its existing portfolio is limited. Acquisitions and development projects should increase its core growth, and DCT's institutional capital management platform offers a definitive exit strategy (and, therefore, continuous source of capital) for its existing asset base.


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## Company Description:

DCT Industrial Trust is a fully integrated Real Estate Investment Trust (REIT) focused on the operation, management, acquisition and development of bulk distribution and light industrial properties. The company operates in 25 US markets with a total portfolio size of over 60 million sq. ft. The company operated as a privately held public REIT from 2002 through 2006, and held its initial public offering in late 2006.

### Table 1: Variance Analysis For DCT

**DCT -- Variance Analysis**
(in millions, except per share data)

| | Actual Q1'10 | Estimate Q1'10E | $ variance | % variance | per share variance |
|---|---|---|---|---|---|
| Rental Property | $57.99 | $58.58 | -$0.59 | -1.0% | -$0.002 |
| Institutional Capital Mgmt & Others | $0.64 | $0.65 | -$0.01 | -2.0% | $0.000 |
| Total Revenue | $58.63 | $59.23 | -$0.60 | -1.0% | $0.00 |
| Operating Expenses | $8.79 | $8.20 | $0.58 | 7.1% | $0.002 |
| Margin | 15.2% | 14.0% | 1.2% | | 0.0% |
| Taxes | $9.28 | $8.70 | $0.58 | 6.7% | $0.002 |
| Utilities | $0.00 | $0.00 | $0.00 | n/a | $0.000 |
| G&A | $5.65 | $6.65 | -$1.00 | -15.0% | -$0.004 |
| Depreciation / Amort | $28.59 | $29.42 | -$0.83 | -2.8% | -$0.003 |
| Others | $0.00 | $0.00 | $0.00 | n/a | $0.000 |
| Total Expenses | $52.31 | $52.97 | -$0.66 | -1.3% | $0.00 |
| **NOI** | **$40.56** | **$42.33** | **-$1.77** | -4.2% | **-$0.01** |
| **EBITDA** | **$34.91** | **$35.68** | **-$0.77** | -2.2% | **$0.00** |
| Interest Income / Others | -$0.86 | $0.37 | -$1.24 | -331.4% | -$0.01 |
| Interest Expense | -$12.79 | -$12.71 | -$0.08 | 0.6% | $0.00 |
| Gain on Dispositions / Others | -$0.24 | $0.00 | -$0.24 | n/a | $0.00 |
| Equity in Earnings JV | -$0.61 | $0.53 | -$1.14 | n/a | $0.00 |
| Income from Disco | -$0.04 | $0.00 | -$0.04 | n/a | $0.00 |
| Minority Interest | $1.00 | $0.55 | $0.45 | 81.3% | $0.00 |
| Preferred Dividend | $0.00 | $0.00 | $0.00 | n/a | $0.00 |
| Net Income | -$7.22 | -$4.99 | -$2.23 | 44.7% | -$0.01 |
| Depreciation / Amort | $28.59 | $29.42 | -$0.83 | -2.8% | $0.00 |
| JV Depreciation / Adjustment | $2.01 | $1.82 | $0.20 | 10.8% | $0.00 |
| Gains / Others | -$0.57 | -$0.23 | -$0.34 | n/a | $0.00 |
| Funds from Operations | $22.82 | $26.02 | -$3.20 | -12.3% | |
| Straight-Line Rent | -$1.20 | -$0.44 | -$0.76 | 173.7% | $0.00 |
| TI / LC Costs | -$2.80 | -$7.43 | $4.63 | -62.3% | $0.02 |
| Maintenance Cap-ex | -$1.89 | -$2.00 | $0.11 | -5.4% | $0.00 |
| Add Back / Others | $1.43 | $3.55 | -$2.12 | -59.8% | -$0.01 |
| Funds After Distribution | $18.35 | $19.70 | -$1.35 | -6.8% | |
| Shares | 237.48 | 237.25 | 0.24 | 0.1% | |
| **FFO/Share** | **$0.10** | **$0.11** | **-$0.01** | -12.4% | |
| **FAD/Share** | **$0.08** | **$0.08** | **-$0.01** | -6.9% | |
| Dividends | $0.07 | $0.07 | $0.00 | 0.0% | |
| Cash flow retention | $1.73 | $3.09 | -$1.36 | -44.1% | |

Source: Wells Fargo Securities, LLC estimates; company reports

## Table 2: Capex Trend For DCT

### DCT Industrial - Quarterly Cap-ex Trends

| | Bulk sf leased (in 000's) | term | costs (in 000's) | cost/sf | cost/sf/yr | chg | Light sf leased (in 000's) | term | costs (in 000's) | cost/sf | cost/sf/yr | chg | Service sf leased (in 000's) | term | costs (in 000's) | cost/sf | cost/sf/yr | chg | Total sf leased (in 000's) | term | costs (in 000's) | cost/sf | cost/sf/yr | chg |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| q406 | 2028 | 51.1 | 3032 | $ 1.50 | $ 0.35 | | 310 | 40.7 | 759 | $ 2.45 | $ 0.72 | | 55 | 38.6 | 100 | $ 1.82 | $ 0.57 | | 2393 | 49.5 | 3891 | $ 1.63 | $ 0.39 | |
| q107 | 1228 | 48.3 | 1507 | $ 1.23 | $ 0.30 | -13% | 271 | 46.4 | 904 | $ 3.34 | $ 0.86 | 20% | 53 | 38.6 | 276 | $ 5.21 | $ 1.62 | 186% | 1552 | 47.6 | 2687 | $ 1.73 | $ 0.44 | 11% |
| q207 | 1748 | 46.8 | 3238 | $ 1.85 | $ 0.47 | 56% | 454 | 45.2 | 888 | $ 1.96 | $ 0.52 | -40% | 96 | 32.9 | 218 | $ 2.27 | $ 0.83 | -49% | 2298 | 45.9 | 4344 | $ 1.89 | $ 0.49 | 13% |
| q307 | 1405 | 53.9 | 3502 | $ 2.49 | $ 0.55 | 17% | 296 | 41.3 | 568 | $ 1.92 | $ 0.56 | 7% | 101 | 47.4 | 420 | $ 4.16 | $ 1.05 | 27% | 1802 | 51.5 | 4490 | $ 2.49 | $ 0.58 | 18% |
| q407 | 1333 | 43.9 | 1987 | $ 1.49 | $ 0.41 | -27% | 396 | 42.6 | 761 | $ 1.92 | $ 0.54 | -3% | 129 | 68.1 | 1260 | $ 9.77 | $ 1.72 | 63% | 1858 | 45.3 | 4008 | $ 2.16 | $ 0.57 | -2% |
| q108 | 1576 | 58.4 | 2685 | $ 1.70 | $ 0.35 | -14% | 230 | 38.1 | 393 | $ 1.71 | $ 0.54 | -1% | 54 | 41.1 | 285 | $ 5.28 | $ 1.54 | -10% | 1860 | 55.4 | 3363 | $ 1.81 | $ 0.39 | -31% |
| q208 | 2222 | 33.3 | 2247 | $ 1.01 | $ 0.36 | 4% | 259 | 39.8 | 568 | $ 2.19 | $ 0.66 | 23% | 62 | 47.7 | 189 | $ 3.05 | $ 0.77 | -50% | 2543 | 34.3 | 3004 | $ 1.18 | $ 0.41 | 5% |
| q308 | 3191 | 63.8 | 4791 | $ 1.50 | $ 0.28 | -23% | 194 | 47.6 | 654 | $ 3.37 | $ 0.85 | 29% | 126 | 39.2 | 598 | $ 4.75 | $ 1.45 | 89% | 3511 | 62.0 | 6043 | $ 1.72 | $ 0.33 | -19% |
| q408 | 2208 | 39.3 | 4061 | $ 1.84 | $ 0.56 | 99% | 191 | 35.1 | 526 | $ 2.75 | $ 0.94 | 11% | 80 | 47 | 248 | $ 3.10 | $ 0.79 | -46% | 2479 | 39.2 | 4835 | $ 1.95 | $ 0.60 | 79% |
| q109 | 1759 | 36.6 | 1300 | $ 0.74 | $ 0.24 | -57% | 128 | 35.9 | 222 | $ 1.73 | $ 0.58 | -38% | 45 | 26.8 | 80 | $ 1.78 | $ 0.80 | 1% | 1932 | 36.3 | 1602 | $ 0.83 | $ 0.27 | -54% |
| q209 | 1487 | 43.7 | 2193 | $ 1.47 | $ 0.40 | 67% | 342 | 33.7 | 169 | $ 0.49 | $ 0.18 | -70% | 97 | 31.0 | 256 | $ 2.64 | $ 1.02 | 28% | 1926 | 41.3 | 2618 | $ 1.36 | $ 0.40 | 44% |
| q309 | 2267 | 49.6 | 3833 | $ 1.69 | $ 0.41 | 1% | 540 | 46.1 | 972 | $ 1.80 | $ 0.47 | 166% | 90 | 30.3 | 218 | $ 2.42 | $ 0.96 | -6% | 2897 | 48.3 | 5023 | $ 1.73 | $ 0.43 | 9% |
| q409 | 2685 | 45.4 | 2556 | $ 0.95 | $ 0.25 | -38% | 208 | 39.8 | 569 | $ 2.74 | $ 0.82 | 76% | 97 | 57.1 | 465 | $ 4.79 | $ 1.01 | 5% | 2990 | 45.4 | 3590 | $ 1.20 | $ 0.32 | -26% |
| q110 | 2834 | 56.2 | 4293 | $ 1.51 | $ 0.32 | 29% | 289 | 45.8 | 683 | $ 2.36 | $ 0.62 | -25% | 76 | 45.4 | 263 | $ 3.46 | $ 0.91 | -9% | 3199 | 55.0 | 5239 | $ 1.64 | $ 0.36 | 13% |

### DCT Industrial - Annual Cap-ex Trends

| | Bulk sf leased (in 000's) | term | costs (in 000's) | cost/sf | cost/sf/yr | | Light sf leased (in 000's) | term | costs (in 000's) | cost/sf | cost/sf/yr | | Service sf leased (in 000's) | term | costs (in 000's) | cost/sf | cost/sf/yr | | Total sf leased (in 000's) | term | costs (in 000's) | cost/sf | cost/sf/yr | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2006 | 6589 | 49.3 | 8232 | $ 1.25 | $ 0.30 | | 764 | 48.7 | 2030 | $ 2.66 | $ 0.65 | | 261 | 36.7 | 801 | $ 3.07 | $ 1.00 | | 7614 | 48.8 | 11063 | $ 1.45 | $ 0.36 | |
| 2007 | 5714 | 48.2 | 10234 | $ 1.79 | $ 0.45 | 47% | 1417 | 43.9 | 3121 | $ 2.20 | $ 0.60 | -8% | 379 | 49.5 | 2174 | $ 5.74 | $ 1.39 | 38% | 7510 | 47.4 | 15529 | $ 2.07 | $ 0.52 | 46% |
| 2008 | 9197 | 49.6 | 13784 | $ 1.50 | $ 0.36 | -19% | 874 | 40.1 | 2141 | $ 2.45 | $ 0.73 | 22% | 322 | 43.1 | 1320 | $ 4.10 | $ 1.14 | -18% | 10393 | 48.6 | 17245 | $ 1.66 | $ 0.41 | -22% |
| 2009 | 8198 | 44.4 | 9882 | $ 1.21 | $ 0.33 | -10% | 1218 | 40.5 | 1932 | $ 1.59 | $ 0.47 | -36% | 329 | 37.9 | 1019 | $ 3.10 | $ 0.98 | -14% | 9745 | 43.7 | 12833 | $ 1.32 | $ 0.36 | -12% |

Source: Wells Fargo Securities, LLC; Company reports

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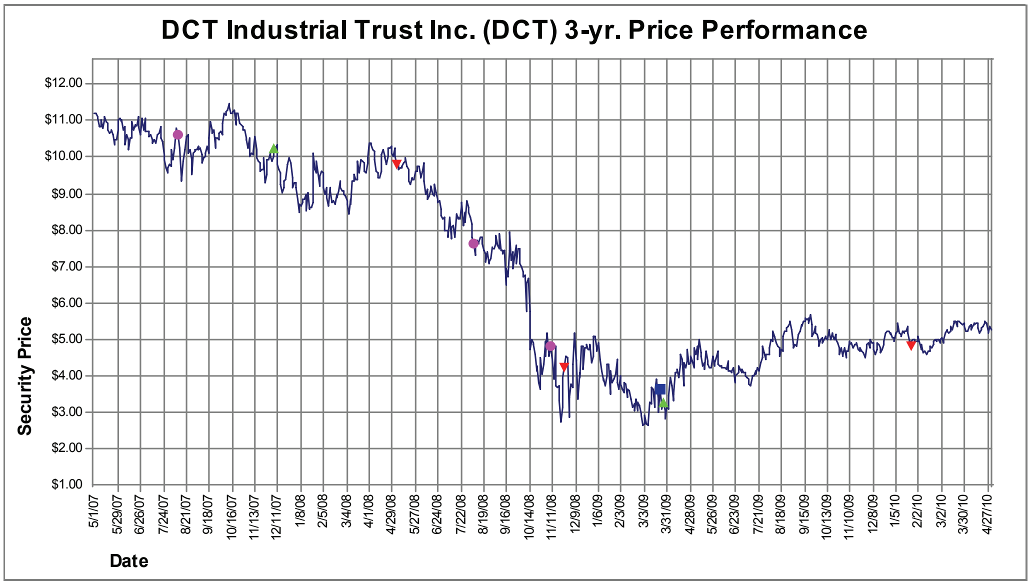


| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 5/1/2007 | | Haley | | | |
| | 5/1/2007 | NA | 2 | 11.00 | 13.00 | 11.21 |
| ● | 8/10/2007 | NA | 2 | 10.00 | 12.00 | 10.62 |
| ▲ | 12/6/2007 | 10.02 | 1 | 10.00 | 12.00 | 10.25 |
| ▼ ● | 5/5/2008 | 10.02 | 2 | 10.00 | 11.00 | 9.80 |
| ● | 8/6/2008 | 7.80 | 2 | 7.00 | 9.00 | 7.62 |
| ● | 11/7/2008 | 4.52 | 2 | 5.00 | 6.00 | 4.83 |
| ▼ | 11/25/2008 | 3.94 | 3 | 5.00 | 6.00 | 4.23 |
| ■ | 3/23/2009 | | Maiorana | | | |
| ▲ ● | 3/26/2009 | 3.10 | 2 | 4.00 | 5.00 | 3.25 |
| ▼ ● | 1/22/2010 | 4.93 | 3 | 4.00 | 4.50 | 4.80 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- ❐ Split Adjustment

**Rating Code Key**
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- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

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| | |
|---|---|
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# *Equity Research*

## Devon Energy Corporation

**DVN: Raising Estimates For 10-Q**

**Outperform / V**

- Raising Estimates. We are updating our estimates as a result of 1Q 2010 results and the filing of the 1Q 2010 10-Q. For 2010, our EPS estimate is $6.31, up from $5.92 previously. For 2011, our EPS estimate is $7.36 up from $7.31 previously.

Sector: Exploration & Production
Market Weight

**Valuation Range: $88.00 to $92.00**
Our valuation range is based on our NAV estimate, which includes value for both proven and unproven reserves, as well as other net assets and liabilities. Our NAV estimate for DVN is $84.08. Risks to our valuation range include overall volatility in commodity prices and divestiture timing and execution risk as the company seeks a new strategic direction.

**Investment Thesis:**
Given recent strategic repositioning, we like the production visibility now inherent in the company's North American asset base as the company targets a 10% CAGR within cash flow over the next 5 years. Longer term, we believe a focus on fewer assets will improve the company's operating and financial metrics.

***Earnings Estimates Revised Up***

| | 2009A | 2010E | | 2011E | |
|---|---|---|---|---|---|
| **EPS** | | **Curr.** | **Prior** | **Curr.** | **Prior** |
| **Q1** (Mar.) | $0.48 | **$1.85 A** | **1.46** | $1.72 | NC |
| **Q2** (June) | 0.88 | **1.37** | **1.38** | 1.62 | NC |
| **Q3** (Sep.) | 0.97 | 1.49 | NC | **1.87** | **1.85** |
| **Q4** (Dec.) | 1.58 | **1.60** | **1.59** | **2.15** | **2.12** |
| **FY** | $3.92 | **$6.31** | **5.92** | **$7.36** | **7.31** |
| **CY** | $3.92 | $6.31 | | $7.36 | |
| **FY P/E** | 16.7x | 10.4x | | 8.9x | |
| **Rev.(MM)** | $8,661 | $11,107 | | $11,911 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

| | |
|---|---|
| Ticker | DVN |
| Price (05/07/2010) | $65.34 |
| 52-Week Range: | $48-77 |
| Shares Outstanding: (MM) | 448.0 |
| Market Cap.: (MM) | $29,272.3 |
| S&P 500: | 1,106.61 |
| Avg. Daily Vol.: | 5,200,370 |
| Dividend/Yield: | $0.45/0.7% |
| LT Debt: (MM) | $5,845.0 |
| LT Debt/Total Cap.: | 23.0% |
| ROE: | 15.0% |
| 3-5 Yr. Est. Growth Rate: | 7.0% |
| CY 2010 Est. P/E-to-Growth: | 1.5x |
| Last Reporting Date: | 05/05/2010 Before Open |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

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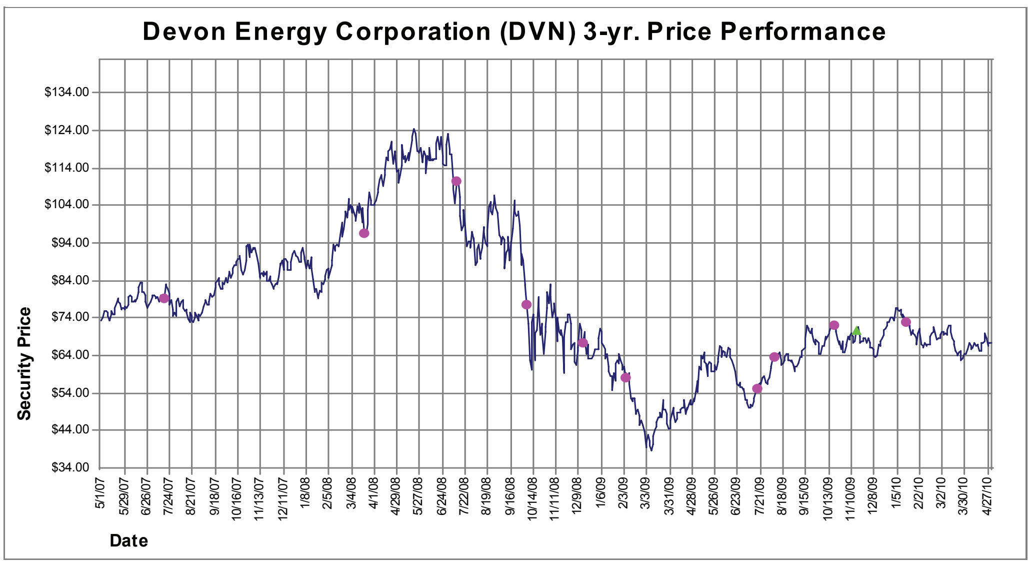
**Please see page 2 for rating definitions, important disclosures and required analyst certifications**

## Company Description:

Devon Energy Corporation's U.S. operations are focused in the Permian Basin, the midcontinent, the Rocky Mountains, and Gulf Coast regions; and Canadian properties are focused in the western Canadian sedimentary basin in Alberta and British Columbia. In November of 2009, Devon Energy announced a strategic restructuring which entails divesting international and offshore properties to focus on North American Onshore operations. At 2009 year-end, its estimated proved reserves attributable to North American Onshore operations were 2.641 billion barrels of oil equivalent. The company was founded in 1971 and is based in Oklahoma City, Oklahoma.

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 5/1/2007 | | Tameron | | | |
| | 5/1/2007 | NA | 2 | 71.00 | 75.00 | 73.09 |
| ● | 7/17/2007 | NA | 2 | 77.00 | 81.00 | 79.41 |
| ● | 3/19/2008 | 103.47 | 2 | 110.00 | 115.00 | 96.75 |
| ● | 7/11/2008 | 109.51 | 2 | 125.00 | 135.00 | 110.34 |
| ● | 10/6/2008 | 73.96 | 2 | 90.00 | 96.00 | 77.40 |
| ● | 12/15/2008 | 68.05 | 2 | 68.00 | 72.00 | 67.30 |
| ● | 2/4/2009 | 58.41 | 2 | 60.00 | 65.00 | 58.09 |
| ● | 7/16/2009 | 54.36 | 2 | 50.00 | 55.00 | 55.29 |
| ● | 8/6/2009 | 63.26 | 2 | 60.00 | 65.00 | 63.37 |
| ● | 10/20/2009 | 71.91 | 2 | 66.00 | 70.00 | 71.99 |
| ▲ ● | 11/17/2009 | 70.99 | 1 | 80.00 | 84.00 | 70.62 |
| ● | 1/15/2010 | 73.97 | 1 | 88.00 | 92.00 | 73.03 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- □ Split Adjustment

**Rating Code Key**
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- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

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As of: May 7, 2010

| | |
|---|---|
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May 7, 2010

WELLS FARGO SECURITIES

# *Equity Research*

## El Paso Pipeline Partners, L.P.

**EPB: Q1 Results Beat Estimates--Raising Estimates/Valuation**

**Market Perform / V**

Sector: Large Cap Pipeline MLPs
Overweight

- **Key Takeaways.** Q1 results beat our forecast and EPB's quarterly distribution increase was in line with expectations. We are increasing our valuation by $1 per unit to reflect a higher five-year distribution CAGR estimate of 9.4% versus 8.5% previously. We are raising our 2010 and 2011 DCF per unit estimates to $2.19, respectively, from $2.05 and $2.14 to reflect Q1 earnings and a modest increase to our base run-rate earnings estimate for Southern Natural Gas (SNG) pipeline. However, we maintain our Market Perform rating as EPB's premium valuation (yield of 5.9% versus large-cap peer group median of 7.0%) fairly reflects the partnership's steady fee-based cash flow stream, visible growth tied to organic projects and dropdowns, and strong GP sponsor support, in our view.
- **Q1 Results Beat Forecast.** Q1 adjusted EBITDA of $134.9MM beat our adjusted estimate of $114.2MM. The variance from our forecast relates primarily to higher SNG equity earnings and the noncash benefit of AFUDC, as well as lower interest expense. Q1 EPU was $0.53 versus our adjusted EPU estimate of $0.46. To note, we adjusted our Q1 estimates to make them comparable to EPB's reported results, as the partnership reported Q1 results as if they owned the recently acquired 51% ownership interest of SLNG and Elba Express for the full quarter (transaction closed on March 30, 2010).
- **DCF Exceeds Estimate--Distribution Increase In Line.** Q1 DCF per unit was $0.64 (versus our adjusted estimate of $0.55), which provided a coverage ratio of 1.6x (excess cash of $34MM). The variance from our estimate is primarily related to lower cash interest expense and the timing of maintenance capex. EPB increased its distribution by 16.9% year/year to $0.38 per unit ($1.52 annualized), which was in line with our forecast and management's guidance.

### *Earnings Estimates Revised Up*

| DCF/unit | 2009A | 2010E Curr. | 2010E Prior | 2011E Curr. | 2011E Prior |
|---|---|---|---|---|---|
| **Q1** (Mar.) | $0.45 | **$0.62 A** | **0.47** | **$0.55** | **0.53** |
| **Q2** (June) | 0.39 | **0.49** | **0.51** | **0.53** | **0.52** |
| **Q3** (Sep.) | 0.42 | 0.52 | NC | **0.54** | **0.53** |
| **Q4** (Dec.) | 0.51 | **0.56** | **0.55** | **0.58** | **0.56** |
| **FY** | $1.81 | **$2.19** | **2.05** | **$2.19** | **2.14** |
| **CY** | $1.81 | $2.19 | | $2.19 | |
| **FY P/DCF** | 14.4x | 11.9x | | 11.9x | |
| **Rev.(MM)** | $359 | $807 | | $907 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

| | |
|---|---|
| Ticker | EPB |
| Price (05/06/2010) | $25.97 |
| 52-Week Range: | $16-29 |
| Shares Outstanding: (MM) | 135.2 |
| Market Cap.: (MM) | $3,511.1 |
| S&P 500: | 1,128.15 |
| Avg. Daily Vol.: | 237,424 |
| Dividend/Yield: | $1.52/5.9% |
| LT Debt: (MM) | $2,078.0 |
| LT Debt/Total Cap.: | 55.0% |
| ROE: | NM |
| 3-5 Yr. Est. Growth Rate: | 9.0% |
| CY 2010 Est. P/DCF/unit-to-Growth: | 1.3x |
| Last Reporting Date: | 05/06/2010 Before Open |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

**Valuation Range: $25.00 to $27.00** **from $24.00 to $26.00**
Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 11.5x our 2010 estimate. Risks to the units trading below our valuation range include a slower-than-forecasted rate of dropdown acquisitions, re-contracting, and rising interest rates.

**Investment Thesis:**
EPB is a high-quality MLP with fee-based cash flow, a visible growth profile, and a strong sponsor. Growth is predicated on (1) expected dropdown acquisitions from its GP sponsor, El Paso Corp, (2) EPB's significant organic growth portfolio, and (3) potential third-party acquisitions. However, this potential is fairly reflected in EPB's premium valuation, in our view. About 80% of EPB's distribution is tax deferred.


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**Please see page 7 for rating definitions, important disclosures and required analyst certifications**

## Company Description:

El Paso Pipeline Partners, L.P. (EPB) is a Texas-based master limited partnership engaged in the transportation and storage of natural gas. The partnership's assets include the Wyoming Interstate Gas pipeline (WIC - 100% interest), Colorado Interstate Gas pipeline (CIG - 58%), Southern Natural Gas pipeline (SNG - 25%), and associated natural gas storage facilities. EPB's general partner and sponsor is El Paso Corporation (EP), the owner of the largest interstate natural gas pipeline system in the United States and a producer of oil and gas reserves.

### Q1 Results Beat Forecast

Q1 adjusted EBITDA of $134.9MM beat our adjusted estimate of $114.2MM. The variance from our forecast relates primarily to higher SNG equity earnings and the noncash benefit from the allowance for funds used during construction (AFUDC), as well as lower interest expense. SNG likely benefited by providing additional spot services to customers due to the cold weather experienced in the U.S. Southeast during Q1. To note, AFUDC is an accounting term that relates to financing costs associated with projects under construction. We do not expect this item to reoccur as most of the partnership's large-scale projects have been placed in-service. Q1 EPU was $0.53 versus our adjusted EPU estimate of $0.46.

NOTE: *In order to make our estimates comparable to EPB's reported results, we adjusted our Q1 estimates to assume that the partnership owned its acquisition of 51% ownership interest of SLNG and Elba Express at the beginning of the quarter. In actuality, the transaction closed on March 30, 2010. Our prior estimates assumed SLNG and Elba Express began contributing at the start of Q2.*

### EPB Q1 Variance

| | | Actuals vs Estimate | | | | | |
|---|---|---|---|---|---|---|---|
| | | Adjusted | | | Unadjusted | | |
| *$ in millions, except per unit data* | **Q1'10A** | **Q1'10E** | **Variance** | **Percent** | **Q1'10E** | **Variance** | **Percent** |
| **Adjusted EBITDA** | **$135** | **$114** | **$21** | **18%** | **$93** | **$42** | **45%** |
| Operating revenue | $188 | $197 | ($9) | (5%) | $142 | $46 | 32% |
| Operating and maintenance | $48 | $56 | ($8) | (15%) | $40 | $8 | 19% |
| Depreciation and amortization | $20 | $24 | ($4) | (19%) | $18 | $1 | 7% |
| Taxes, other than income | $7 | $6 | $1 | 25% | $6 | $1 | 25% |
| **Operating income** | **$114** | **$112** | **$2** | **2%** | **$78** | **$35** | **45%** |
| Earnings from unconsolidated affiliates | $20 | $14 | $6 | 42% | $14 | $6 | 42% |
| Other income, net | $15 | $3 | $12 | 397% | $3 | $12 | 397% |
| Interest and debt expense, net | $18 | $26 | ($8) | (31%) | $18 | ($0) | (0%) |
| **Income before taxes** | **$130** | **$102** | **$28** | **27%** | **$77** | **$53** | **69%** |
| Income tax expense | $2 | $0 | $2 | NA | $0 | $2 | NA |
| **Net income** | **$128** | **$102** | **$26** | **25%** | **$77** | **$51** | **66%** |
| Net income attributable for non-controlling interests | $38 | $37 | $1 | 3% | $20 | $19 | 94% |
| **Reported net income** | **$89** | **$65** | **$24** | **37%** | **$57** | **$32** | **56%** |
| **GP interest in net income** | **$16** | **$3** | **$13** | **358%** | **$3** | **$13** | **435%** |
| **LP interest in net income** | **$73** | **$61** | **$12** | **19%** | **$54** | **$19** | **35%** |
| Earnings per unit (EPU) | $0.53 | $0.46 | $0.07 | 14% | $0.41 | $0.12 | 30% |

Source: Partnership reports and Wells Fargo Securities, LLC estimates

### Liquidity Position/Balance Sheet Update

As of March 31, 2010, the partnership had approximately $2.1B of total debt outstanding. EPB has a $750 million revolving credit facility with approximately $230MM available of borrowing availability. If we include the note receivable from El Paso Corp. (EP) and $71MM of cash on the partnership's balance sheet, EPB's liquidity position was approximately $338MM at the end of Q1, which is more than sufficient to fund its 2010 capex budget of approximately $178MM. At the end of Q1, the partnership's debt-to-EBITDA and EBITDA-to-interest expense ratios were 3.1x and 6.0x, respectively, based on annualized quarterly results. This compares to the large-cap pipeline MLP peer group medians of 3.5x and 4.9x, respectively.

### 2010 Financing Plan Forecast For Growth Capex

| 2010 Capital Requirements | |
|---|---|
| Organic growth | $178 |
| Acquisition - completed | $810 |
| **Total capex** | **$988** |
| | |
| Senior notes | $0 |
| **Total debt maturities** | **$0** |
| | |
| **Total estimated capex requirements** | **$988** |

| 2010 Funding | |
|---|---|
| Revolving credit facility / (Repayment) | $90 |
| Senior notes offering - completed | $425 |
| **Total debt funding** | **$515** |
| | |
| Secondary issuances - completed | $385 |
| **Total equity funding** | **$385** |
| | |
| **Other** (i.e. excess cash flow estimate) | **$88** |
| | |
| **Total estimated funding** | **$988** |
| **Pro forma 2010E debt-to-EBITDA** | **3.3x** |
| **Unadjusted 2010E debt-to-EBITDA** | **3.5x** |

| Pro Forma 2010E Debt-to-EBITDA Calculation | |
|---|---|
| Total net debt balance | $1,734 |
| 2010E EBITDA | $500 |
| (+) Adj. FY contributions from 2010 capex | $25 |
| Pro forma 2010E EBITDA | $525 |
| **Pro forma debt-to-EBITDA** | **3.3x** |

Source: Wells Fargo Securities, LLC estimates

### DCF Exceeds Estimate--Distribution Increase In Line

Q1 DCF per unit was $0.64 (versus our adjusted estimate of $0.55), which provided a coverage ratio of 1.6x (excess cash of $34MM). The variance from our estimate is primarily related to lower cash interest expense and the timing of maintenance capex. EPB increased its distribution by 16.9% year/year to $0.38 per unit ($1.52 annualized), which was in line with our forecast and management's guidance.

### EPB Q1 DCF Variance

| | | Actuals vs Estimate | | | | | |
|---|---|---|---|---|---|---|---|
| | | Adjusted | | | | | |
| *$ in millions, except per unit data* | Q1'10A | Q1'10E | Variance | Percent | Q1'10E | Variance | Percent |
| Adjusted EBITDA | $135 | $114 | $21 | 18% | $93 | $42 | 45% |
| (-) Cash interest expense | $23 | $26 | ($4) | (15%) | $18 | $4 | 23% |
| (-) Maintenance capital expenditure | $4 | $11 | ($7) | (63%) | $10 | ($6) | (59%) |
| (-) Other | $21 | $1 | $20 | 4020% | $1 | $20 | 4020% |
| Available cash flow | $88 | $77 | $11 | 15% | $65 | $23 | 35% |
| Cash paid to general partner | ($3) | ($3) | $0 | 0% | ($3) | $0 | 0% |
| **Distributable cash flow** | **$85** | **$74** | **$11** | **15%** | **$62** | **$23** | **37%** |
| **Distributable cash flow available per LP unit** | **$0.64** | **$0.55** | **$0.08** | **15%** | **$0.47** | **$0.17** | **37%** |
| **Cash distribution declared per unit** | **$0.380** | **$0.380** | **$0.000** | **0%** | **$0.380** | **$0.000** | **0%** |
| Distribution coverage ratio | 1.63x | 1.42x | 0.21x | 15% | 1.20x | 0.43x | 35% |
| Cash coverage | $34 | $23 | $11 | 50% | $11 | $23 | 212% |

Source: Partnership reports and Wells Fargo Securities, LLC estimates

### Increasing 2010 And 2011 Estimates

We are raising our 2010 and 2011 DCF per unit estimates to $2.19, respectively, from $2.05 and $2.14 to reflect Q1 earnings and a modest increase to our base run-rate earnings estimate for SNG. We are also increasing our 2010 and 2011 EPU forecast to $1.92 and $1.89, respectively, from $1.75 and $1.82.

**2010/2011 Estimate Change Summary**

| | 2010 Estimates | | | | 2011 Estimates | | | |
|---|---|---|---|---|---|---|---|---|
| *$ in millions, except per unit data* | **Revised** | **Previous** | **Variance** | **Percent** | **Revised** | **Previous** | **Variance** | **Percent** |
| EBIT | $473.0 | $445.1 | $27.9 | 6.3% | $511.7 | $522.3 | ($10.7) | (2.0%) |
| Equity in earnings | $71.6 | $55.5 | $16.0 | 28.9% | $72.0 | $61.3 | $10.8 | 17.6% |
| Other income | $16.9 | $5.0 | $11.9 | 238.0% | $5.0 | $5.0 | $0.0 | 0.0% |
| Interest expense, net | $114.0 | $114.7 | ($0.7) | (0.6%) | $138.9 | $148.1 | ($9.3) | (6.2%) |
| Income before taxes | $447.4 | $390.9 | $56.5 | 14.5% | $449.8 | $440.5 | $9.3 | 2.1% |
| Income tax expense | $2.4 | $0.0 | $2.4 | -- | $0.0 | $0.0 | $0.0 | -- |
| Net income | $445.0 | $390.9 | $54.1 | 13.8% | $449.8 | $440.5 | $9.3 | 2.1% |
| Net income attributable to non-controlling interest | $148.7 | $133.7 | $15.0 | 11.2% | $156.1 | $161.0 | ($4.9) | (3.0%) |
| Net income attributable to EPB | $296.3 | $257.3 | $39.1 | 15.2% | $293.7 | $279.5 | $14.2 | 5.1% |
| **EPU** | **$1.92** | **$1.75** | **$0.17** | **9.8%** | **$1.89** | **$1.82** | **$0.08** | **4.2%** |
| **EBITDA** | **$499.7** | **$455.1** | **$44.6** | **9.8%** | **$519.8** | **$518.0** | **$1.8** | **0.3%** |
| **Available cash flow** | **$317.8** | **$296.1** | **$21.7** | **7.3%** | **$332.8** | **$321.8** | **$11.0** | **3.4%** |
| Cash paid to general partner (GP) | ($11.9) | ($11.8) | ($0.1) | 0.8% | ($20.2) | ($16.7) | ($3.5) | 21.0% |
| **Distributable cash flow (DCF)** | **$305.9** | **$284.3** | **$21.6** | **7.6%** | **$312.7** | **$305.1** | **$7.5** | **2.5%** |
| **DCF per unit** | **$2.19** | **$2.05** | **$0.14** | **6.8%** | **$2.19** | **$2.14** | **$0.05** | **2.5%** |
| Distribution per unit | $1.55 | $1.55 | $0.00 | 0.0% | $1.69 | $1.65 | $0.05 | 2.7% |
| Distribution coverage ratio | 1.38x | 1.30x | 0.08x | 6.3% | 1.27x | 1.28x | (0.01x) | (0.5%) |
| Cash coverage | $88.1 | $68.4 | $19.6 | 28.6% | $71.5 | $70.3 | $1.2 | 1.7% |

Source: Wells Fargo Securities, LLC estimates

**Raising Valuation Range To $25-27 Per Unit From $24-26 Per Unit**

We are raising our valuation range by $1 per unit to $25-27 per unit to reflect an increase to our five-year distribution CAGR forecast to 9.4% from 8.5% previously. The increase to our distribution growth estimate is supported by higher base business cash flows (i.e. from SNG). Our valuation range of $25-27 per unit is predicated on a combination of a dividend discount model and price-to-DCF multiple. Our DDM model yields a valuation of $27 per unit, and assumes a long term distribution growth rate of 1.25%, and a required rate of return of 8.5%. The low-end of our valuation range reflects a price-to-DCF multiple of about 11.5x our 2010 DCF per unit estimate of $2.19. Risks to the units trading below our valuation range include a slower-than-forecast rate of dropdown acquisitions, recontracting, and rising interest rates.

EPB currently yields 5.9% and trades at 2010E and 2011E price-to-distributable cash flow multiples of 11.9x and 11.8x, respectively. This compares to the large-cap MLP pipeline peer group median of 7.0%, 12.4x, and 11.8x, respectively. Our 2010 and five-year distribution growth estimates for EPB are 13.6% and 9.4%, respectively, as compared to the large-cap MLP pipeline peer group median of 4.3% and 4.7%.

**EPB Versus The Peer Group**

| | | Price | | Price/DCF | | Distr. Growth Ests. | | |
|---|---|---|---|---|---|---|---|---|
| **MLP** | **Ticker** | **5/6/10** | **Yield** | **2010E** | **2011E** | **1-year** | **3-year** | **5-year** |
| El Paso Pipeline Partners, L.P. | EPB | $25.97 | 5.9% | 11.9x | 11.8x | 13.6% | 11.0% | 9.4% |
| Large Cap Pipeline MLP Median | | | 7.0% | 12.4x | 11.8x | 4.3% | 5.1% | 4.7% |

Source: FactSet and Wells Fargo Securities, LLC estimates

## EL PASO PIPELINE PARTNERS, L.P. - OPERATIONAL SUMMARY

| *Year ended December 31*<br>*($ in millions, except for per unit data)* | FY2009A | Q1'10A | Q2'10E | Q3'10E | Q4'10E | FY2010E | FY2011E | FY2012E | FY2013E | FY2014E |
|---|---|---|---|---|---|---|---|---|---|---|
| **Total adjusted EBITDA** | **298** | 135 | 117 | 121 | 126 | **500** | **520** | **590** | **660** | **719** |
| EPU | **$1.59** | $0.53 | $0.43 | $0.46 | $0.50 | **$1.92** | **$1.89** | **$1.84** | **$1.81** | **$1.77** |
| Average units outstanding | **119** | 138 | 141 | 141 | 141 | **140** | **143** | **150** | **158** | **163** |
| **Distributable cash flow (DCF)** | | | | | | | | | | |
| Adjusted EBITDA | **298** | 135 | 117 | 121 | 126 | **500** | **520** | **590** | **660** | **719** |
| (-) Cash interest expense | **47** | 23 | 32 | 32 | 32 | **118** | **139** | **162** | **184** | **204** |
| (-) Maintenance capital expenditure | **17** | 4 | 12 | 13 | 13 | **41** | **46** | **47** | **51** | **56** |
| (-) Other | **13** | 21 | 1 | 1 | 1 | **22** | **2** | **2** | **2** | **2** |
| **Available cash flow** | **221** | 88 | 72 | 76 | 82 | **318** | **333** | **378** | **424** | **457** |
| General partner's interest | **5** | 3 | 3 | 3 | 3 | **12** | **20** | **43** | **68** | **91** |
| **Distributable cash flow** | **216** | 85 | 69 | 73 | 78 | **306** | **313** | **335** | **355** | **367** |
| DCF per unit | **$1.81** | $0.62 | $0.49 | $0.52 | $0.56 | **$2.19** | **$2.19** | **$2.23** | **$2.25** | **$2.25** |
| Cash distribution declared per unit | **$1.37** | $0.38 | $0.39 | $0.39 | $0.40 | **$1.55** | **$1.69** | **$1.87** | **$2.02** | **$2.14** |
| *% sequential distribution growth* | | *5.6%* | *1.3%* | *1.3%* | *1.3%* | | | | | |
| *% yr/yr distribution growth* | *13.5%* | *16.9%* | *16.7%* | *11.4%* | *9.7%* | *13.6%* | *9.0%* | *10.5%* | *7.9%* | *6.2%* |
| Distribution coverage | **1.22x** | 1.56x | 1.27x | 1.32x | 1.39x | **1.38x** | **1.27x** | **1.17x** | **1.10x** | **1.04x** |
| Excess cash flow | **41** | 32 | 15 | 18 | 23 | **88** | **72** | **54** | **37** | **18** |
| **% of total cash distribution** | | | | | | | | | | |
| General partner | **2.6%** | 4.7% | 5.0% | 5.3% | 5.7% | **5.2%** | **7.7%** | **13.3%** | **17.7%** | **20.7%** |
| Limited partners | **97.4%** | 95.3% | 95.0% | 94.7% | 94.3% | **94.8%** | **92.3%** | **86.7%** | **82.3%** | **79.3%** |
| Maximum potential distribution (MPD) | **$1.68** | | | | | **$1.90** | **$1.96** | **$2.05** | **$2.13** | **$2.20** |
| **Capital expenditures** | | | | | | | | | | |
| Maintenance capex | **17** | 4 | 12 | 13 | 13 | **41** | **46** | **47** | **51** | **56** |
| Growth capex | **128** | 39 | 68 | 43 | 29 | **178** | **104** | **82** | **75** | **75** |
| Acquisitions / "Dropdowns" | **215** | 810 | 0 | 0 | 0 | **810** | **500** | **500** | **500** | **0** |
| **Total capex** | **360** | 853 | 80 | 55 | 42 | **1,029** | **650** | **629** | **626** | **131** |
| **Credit and operating metrics** | | | | | | | | | | |
| Equity issuances *($ in millions)* | **217** | 385 | 0 | 0 | 0 | **385** | **250** | **250** | **0** | **0** |
| Total debt *($ in millions)* | **1,081** | 1,656 | 1,696 | 1,723 | 1,734 | **1,734** | **2,013** | **2,286** | **2,569** | **2,623** |
| Debt/cap | **53.9%** | 55.2% | 61.2% | 61.6% | 61.6% | **61.6%** | **60.9%** | **60.3%** | **60.3%** | **62.5%** |
| Debt/EBITDA (run-rate) | **2.5x** | 3.1x | 3.6x | 3.6x | 3.4x | **3.4x** | **3.5x** | **3.6x** | **3.6x** | **3.5x** |
| EBITDA/interest expense | **6.0x** | 6.0x | 4.9x | 4.7x | 4.4x | **4.4x** | **3.7x** | **3.6x** | **3.6x** | **3.6x** |
| Maintenance capex as a % of EBITDA | 6% | 3% | 11% | 10% | 10% | 8% | 9% | 8% | 8% | 8% |

Source: Partnership reports and Wells Fargo Securities, LLC estimates

## MLP Glossary Of Terms

**Available Cash Flow:** Available cash flow is the cash flow available to the common unitholders and the general partner.

**Backwardation:** A market condition in which future commodity prices are lower than spot prices. A backwardated market usually occurs when demand exceeds supply.

**Contango:** A market condition in which future commodity prices are greater than spot prices. The higher future price is often due to the cost associated with storing and insuring the underlying commodity.

**British Thermal Unit (Btu):** A unit of measurement for energy representing the amount of heat required to raise the temperature of one pound of water one degree Fahrenheit.

**Current Yield:** The current yield is calculated by taking the current declared quarterly distribution annualized and dividing it by current stock price.

**Dekatherm:** A dekatherm is a measurement of energy content. One dekatherm is the approximate energy content of 1,000 cubic feet of natural gas (or 1 Mcf).

**Distributable Cash Flow (DCF):** DCF is the cash flow available to be paid to common unitholders after payments to the general partner.

**Distribution (Dividend) Discount Model (DDM):** DDM is an equity valuation tool used to estimate the present value of a stock based on the expected distributions (or dividends/future cash flow) received from the company.

**Distribution:** In a typical partnership agreement, the MLP is required to distribute all of its "available cash." MLPs typically distribute all available cash flow (i.e. cash flow from operations less maintenance CAPEX) to unitholders in the form of distributions (similar to dividends). However, management typically has some discretion in how much cash flow they choose to pay out.

**Distribution Coverage Ratio:** The coverage ratio indicates the cash available for distribution for every dollar to be distributed. The ratio is calculated by dividing available cash flow by distributions paid. Investors typically associate as the "cushion" a partnership has in paying its cash distribution. In this context, the higher the ratio, the greater the safety of the distribution.

**Dropdown:** A dropdown is the sale of an asset from the parent company (or sponsor company) to the underlying partnership. Dropdowns can also be defined as a transaction between two affiliated companies.

**Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA):** EBITDA is a non-GAAP measure used to provide an approximation of a company's profitability. This measure excludes the potential distortion that accounting and financing rules may have on a company's earnings; therefore, EBITDA is a useful tool when comparing companies that incur large amounts of depreciation expense because it excludes these non-cash items which could understate the company's true performance.

**Earnings Per Unit (EPU):** An MLPs' EPU is synonymous with a C corp.'s earnings per share (EPS). EPU is calculated by dividing net income allocated to the limited partners divided by the weighted average units outstanding at the end of the period.

**EBITDA Multiple:** An EBITDA multiple is the expected return an acquisition or organic growth project is estimated to generate. For example, a $100 million investment at an 8x EBITDA multiple, would be expected to generate approximately $12.5 million of EBITDA on an annual basis (or a 12.5% return).

**Excess Cash Flow:** Excess cash flow is the cash flow that remains after distributions have been paid to common and subordinated unitholders and general partner.

**Fractionation:** Fractionation is the process that involves the separation of the NGLs into discrete NGL purity products (i.e. ethane, propane, normal butane, iso-butane, and natural gasoline).

**Frac Spread (also known as "Processing Margin"):** The processing margin is the difference between the price of natural gas and a composite price for NGLs on a BTU-equivalent basis.

**General Partner (GP):** The GP (1) manages the day-to-day operations of the partnership, (2) generally has a 2% ownership stake in the partnership, and (3) is eligible to receive an incentive distribution (through the ownership of the MLPs' incentive distribution rights).

**Incentive Distribution Rights (IDRs):** IDRs allow the holder (typically the general partner) to receive an increasing percentage of quarterly distributions after the MQD and target distribution thresholds have been achieved. In most partnerships, IDRs can reach a tier wherein the GP is receiving 50% of every incremental dollar paid to the LP unitholders. This is known as the 50/50 or "high splits" tier.

**Limited Partner (LP):** The LP (1) provides capital, (2) has no role in the MLPs' operations or management, and (3) receives cash distributions.

**Liquid Petroleum Gases (LPGs):** LPGs are created (as a byproduct) during the refining of crude oil or from natural gas production. LPGs are typically a mixed form of propane and butane.

**Maintenance Capital Expenditures (CAPEX):** Maintenance CAPEX is the investment required to maintain the partnership's existing asset.

**Natural Gas Liquids (NGLs):** NGLs are extracted from the raw natural gas stream into a liquid mix (consisting of ethane, propane, butane, iso-butane, and natural gasoline). The NGLs are then typically transported via pipelines to fractionation facilities.

**Organic Growth Capital Expenditures (CAPEX):** Organic CAPEX is investments used to expand a company's operating capacity or operating income over the long-term.

**Processing:** Natural gas processing involves the separation of raw natural gas into "pipeline quality" gas and natural gas liquids.

**Tax Deferral Rate:** A percentage of the cash distribution to the unitholder that is tax deferred until the security is sold. The tax deferral rate on distributions ranges from 40-90%. The tax deferral rate is an approximation provided by the partnership and is only effective for a certain period of time.

## Energy Industry Abbreviations

**Bbls:** Barrels

**Bcf/d:** One billion cubic feet per day

**MBtu:** One thousand Btus.

**Mcf:** One thousand cubic feet of natural gas.

**MBbls:** One thousand barrels.

**MBbls/d:** One thousand barrels per day.

**MM:** In millions.

**MMBbls:** One million barrels.

**MMBbls/d:** One million barrels per day.

**MMBtu:** One million Btus.

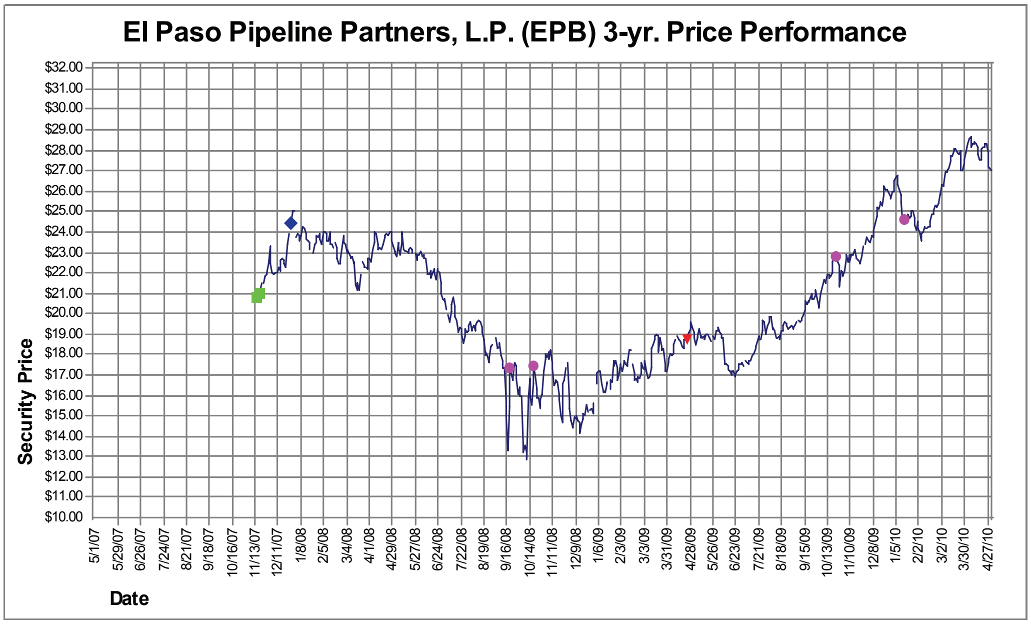
**MMBtu/d:** One million Btus per day.

**MMcf:** One million cubic feet of natural gas.

**MMcf/d:** One million cubic feet of natural gas per day.

**Tcf:** One trillion cubic feet of gas.

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| ❐ | 11/16/2007 | | IPO at $20.00 | | | |
| | 12/26/2007 | | Blum | | | |
| ◆ | 12/26/2007 | 23.94 | 1 | 26.00 | 28.00 | 24.43 |
| ● | 9/19/2008 | 17.38 | 1 | 23.00 | 25.00 | 17.38 |
| ● | 10/20/2008 | 16.59 | 1 | 18.00 | 20.00 | 17.45 |
| ▼ | 4/24/2009 | 19.01 | 2 | 18.00 | 20.00 | 18.76 |
| ● | 10/22/2009 | 22.76 | 2 | 22.00 | 24.00 | 22.81 |
| ● | 1/15/2010 | 24.44 | 2 | 24.00 | 26.00 | 24.57 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- ❐ Split Adjustment

**Rating Code Key**

| | | | |
|---|---|---|---|
| 1 | Outperform/Buy | SR | Suspended |
| 2 | Market Perform/Hold | NR | Not Rated |
| 3 | Underperform/Sell | NE | No Estimate |

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As of: May 7, 2010

| | |
|---|---|
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May 7, 2010

WELLS FARGO SECURITIES

# *Equity Research*

## Encore Energy Partners, L.P.

**ENP: Q1 Operating Results In Line--Raising Estimates**
**Thesis Intact--Strategic Buyer To Emerge--Maintain Outperform**

**Outperform / V**

Sector: Upstream MLPs
Market Weight

- **Key Takeaways.** Q1 EBITDA was in line with our forecast; DCF beat. ENP and Denbury's (DNR) earnings conference call served to reinforce our recent upgrade and investment thesis for the MLP, following DNR's announcement late last week that it is reviewing strategic alternatives for ENP (i.e. sale, merger, or other transaction). Management indicated that it would act in the interest of ENP unitholders and is unlikely to execute on a transaction that results in cash flow or net asset value dilution to ENP unitholders. Separately, Legacy Reserves (LGCY) noted on its earnings call that ENP was a "great fit" for LGCY, confirming our view that ENP is likely to receive multiple bids given its highly desirable, MLP-appropriate asset base. We are raising our 2010 DCF per unit estimate to \$2.56 from \$2.53 primarily to reflect the Q1 variance. We are maintaining our Outperform rating as we view ENP's 11.5% yield as secure based on our price deck with upside tied to a sale of the partnership.

- **Q1 Operating Results In Line With Forecast--DCF Slightly Higher.** Q1 adjusted EBITDA of \$31.8MM was in line with our estimate of \$30.6MM as higher realized sales prices offset higher lease operating expenses. Adjusted EPU of \$0.29 was also in line with our estimate of \$0.27 and consensus of \$0.28. Q1 adjusted EBITDA of \$31.8MM was in line with our estimate of \$30.6MM. DCF per unit of \$0.61 was slightly ahead of our estimate of \$0.57 primarily due to lower maintenance capex.

- **Variable Distribution Policy Maintained.** ENP declared a Q1 2010 distribution of \$0.50 (\$2.00 annualized), which was ahead of our forecast of \$0.475 (\$1.90 annualized) and represents a 7.0% sequential decrease from \$0.5375 in Q4 2009. As a reminder, ENP is unique among upstream MLPs, as it employs a variable rate distribution policy whereby the partnership pays a minimum annual distribution of \$1.73 and then (1) distributes 50% of excess cash flow above this level and a minimum 1.1x coverage ratio to unitholders and (2) retains the remaining 50% of excess cash flow to pay down debt. Based on the aforementioned distribution formula and our crude oil price deck (about \$83/bbl over the balance of the year), we estimate ENP will maintain its current distribution of \$0.50 per unit over the balance of the year. Importantly, Denbury management indicated that it intends to continue the distribution policy in accord with the prior ENP management.

### *Earnings Estimates Revised Up*

| DCF/unit | 2009A | 2010E Curr. | 2010E Prior | 2011E Curr. | 2011E Prior |
|---|---|---|---|---|---|
| **Q1** (Mar.) | \$0.78 | **\$0.61 A** | **0.57** | \$0.61 | NC |
| **Q2** (June) | 0.79 | 0.61 | NC | 0.61 | NC |
| **Q3** (Sep.) | 0.76 | 0.68 | NC | 0.68 | NC |
| **Q4** (Dec.) | 0.80 | 0.66 | NC | 0.67 | NC |
| **FY** | \$3.14 | **\$2.56** | **2.53** | \$2.57 | NC |
| **CY** | \$3.14 | \$2.56 | | \$2.57 | |
| **FY P/DCF** | 5.6x | 6.8x | | 6.8x | |
| **Rev.(MM)** | \$179 | \$209 | | \$237 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

| | |
|---|---|
| Ticker | ENP |
| Price (05/07/2010) | \$17.43 |
| 52-Week Range: | \$9-22 |
| Shares Outstanding: (MM) | 45.3 |
| Market Cap.: (MM) | \$789.6 |
| S&P 500: | 1,120.79 |
| Avg. Daily Vol.: | 540,400 |
| Dividend/Yield: | \$2.00/11.5% |
| LT Debt: (MM) | \$250.0 |
| LT Debt/Total Cap.: | 62.0% |
| ROE: | NM |
| 3-5 Yr. Est. Growth Rate: | 0.0% |
| CY 2010 Est. P/DCF/unit-to-Growth: | NM |
| Last Reporting Date: | 05/06/2010 Before Open |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

**Valuation Range: \$21.00 to \$23.00**
Our valuation range is based on a blend of (1) our three-stage discounted free-cash flow model, which assumes a 11% required rate of return and a long-term growth rate of 0%, and (2) a price-to-distributable cash flow multiple of about 8.5x our 2010 estimate. Risks to the units trading below our range include a dependence on acquisitions to fuel growth and partially offset the depletion of reserves, the inability to hedge at favorable prices, and rising interest rates.

**Investment Thesis:**
Risk/reward seems favorable, in our view, as Encore owns high quality, MLP appropriate assets, which are likely to be attractive to other upstream MLPs, private equity, and other strategic buyers. About 80% of ENP's distribution is tax deferred.


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**Please see page 8 for rating definitions, important disclosures and required analyst certifications**

## Company Description:

Encore Energy Partners, L.P. is a Texas-based master limited partnership involved in the acquisition, production, and development of oil and natural gas properties. The partnership's reserves are primarily crude oil located in West Texas, the Mid-Continent and the Rockies. ENP's general partner and sponsor is Encore Acquisition Company (NYSE: EAC), an independent exploration and production company engaged in the development of onshore North American crude oil and natural gas reserves.

### Q1 Results In Line With Forecast

Q1 adjusted EBITDA of $31.8MM was in line with our estimate of $30.6MM as higher realized sales prices ($61.85 per boe versus our estimate of $59.36) offset higher lease operating expenses ($14.29 per boe versus our estimate of $12.50 per boe). Adjusted EPU of $0.29 was also in line with our estimate of $0.27 and consensus of $0.28.

**Figure 1. Q1 2010 Results Versus Our Estimates**

| | *($MM, except per unit data)* | Q1'09A | Q4'09A | Q1'10A | Q1'10E | Var ($) | Var (%) |
|---|---|---|---|---|---|---|---|
| Prod. | Realized sales price ($/Boe) [1] | $73.01 | $68.65 | **$61.85** | $59.36 | $2.49 | 4% |
| | Total production (MBoe) | 580 | 851 | **813** | 816 | (3) | (0%) |
| | Daily production (Boe/d) | 6,443 | 9,254 | **9,034** | 9,071 | (37) | (0%) |
| Income Statement | Total revenue | $36.9 | $52.6 | **$47.9** | $46.1 | $1.9 | 4% |
| | LOE & workover expenses | $7.3 | $10.6 | **$11.6** | $10.2 | $1.4 | 14% |
| | Production taxes | $2.2 | $4.5 | **$5.1** | $5.1 | $0.0 | 0% |
| | Cash G&A expenses | $1.9 | $2.1 | **$1.9** | $2.3 | ($0.4) | (17%) |
| | DD&A expenses | $10.4 | $13.1 | **$12.9** | $12.7 | $0.2 | 2% |
| | Other expenses, net | $0.9 | $0.5 | **$0.0** | $0.5 | ($0.5) | (96%) |
| | Total operating expenses | $22.6 | $30.7 | **$31.4** | $30.7 | $0.8 | 3% |
| | Adjusted EPU | $0.36 | $0.41 | **$0.29** | $0.27 | $0.01 | 5% |
| | Adjusted EBITDA | $30.3 | $41.0 | **$31.8** | $30.6 | $1.2 | 4% |
| | Interest expense | $2.2 | $3.4 | **$3.4** | $2.9 | $0.5 | 16% |
| | Development capex | $2.1 | $1.0 | **$0.5** | $1.5 | ($1.0) | (65%) |
| | DCF (before GP interest) | $25.9 | $36.7 | **$27.9** | $26.2 | $1.7 | 7% |
| | DCF per unit | $0.78 | $0.80 | **$0.61** | $0.57 | $0.04 | 6% |
| | DCF / unit (25% mcapex) [2] | | $0.60 | **$0.44** | $0.44 | $0.01 | 2% |
| | Distribution per unit | $0.50 | $0.54 | **$0.50** | $0.50 | $0.00 | 0% |
| | Coverage ratio | 1.55x | 1.49x | **1.22x** | 1.14x | 0.1x | 7% |
| | Excess cash flow | $9.2 | $12.0 | **$4.9** | $3.2 | $1.7 | 53% |
| Per Boe | LOE & workover per Boe | $12.52 | $12.40 | **$14.29** | $12.50 | $1.79 | 14% |
| | Production taxes (% of rev) | 12.1% | 9.7% | **10.4%** | 11.0% | (0.6%) | (5%) |
| | Total production costs per Boe | $16.37 | $17.70 | **$20.52** | $18.69 | $1.83 | 10% |

Note 1: Includes effect of hedges; excludes non-cash amortized premiums
Note 2: Calculates DCF per unit assuming 25% of EBITDA is held back as maintenance capex
Source: Partnership reports and Wells Fargo Securities, LLC estimates

DCF per unit of $0.61 was slightly ahead of our estimate of $0.57 primarily due to lower maintenance capex ($0.5MM versus our estimate of $1.5MM). Unlike other upstream MLPs, ENP does not hold back a set amount of capital each quarter to replace production and reserves (i.e., maintenance capex). The partnership's development budget fluctuates based on drilling opportunities, commodity prices, and service costs.

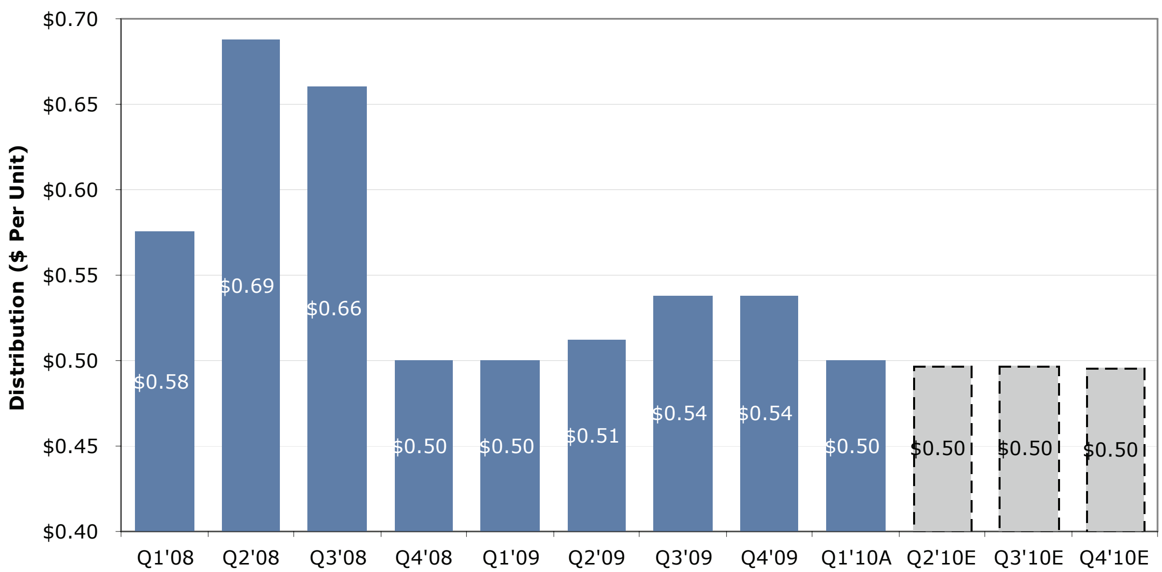
### Denbury Maintains Encore's Distribution Policy--Q1 2010 Distribution Reduced 7.0%

ENP declared a Q1 2010 distribution of $0.50 ($2.00 annualized), which was ahead of our forecast of $0.475 ($1.90 annualized) and represents a 7.0% sequential decrease from $0.5375 in Q4 2009. Notably, our distribution estimate was predicated on our previous DCF per unit estimate of $0.57. In contrast, ENP reported DCF per unit of $0.61, which enabled the partnership to declare a higher distribution relative to our forecast.

As a reminder, ENP is unique among upstream MLPs, as it employs a variable rate distribution policy whereby the partnership pays a minimum annual distribution of $1.73 and then (1) distributes 50% of excess cash flow above this level and a minimum 1.1x coverage ratio to unitholders and (2) retains the remaining 50% of excess cash flow to pay down debt.

Based on the aforementioned distribution formula and our crude oil price deck (about $83/bbl over the balance of the year), we estimate ENP will maintain its current distribution of $0.50 per unit over the balance of the year. Importantly, Denbury management indicated that it intends to continue the distribution policy in accord with the prior ENP management.

**Figure 2. Historical And Forecast Quarterly Distributions**




Note: Excludes our acquisition assumptions and assumes crude oil prices of ~$83/Bbl for Q2-Q4'10
Source: Partnership reports and Wells Fargo Securities, LLC estimates

**Exploring Strategic Alternatives For ENP**

On April 30, 2010, ENP's GP owner Denbury Resources announced that it was reviewing "strategic alternatives" for the MLP including "a possible merger, sale or other transaction." Denbury's decision to monetize its interest in ENP is in light of the company's recently announced sale of MLP appropriate reserves to Quantum Resources Management for $900MM. These assets were previously assumed to be "dropdown" candidates to ENP over time. Additionally, on its earnings conference call, Denbury indicated that given the company's enhanced oil recovery strategy, it does not intend to pursue MLP appropriate acquisitions of mature, long-lived properties. Thus, ENP no longer fits the company's strategic focus.

**Reviewing Potential Outcomes**

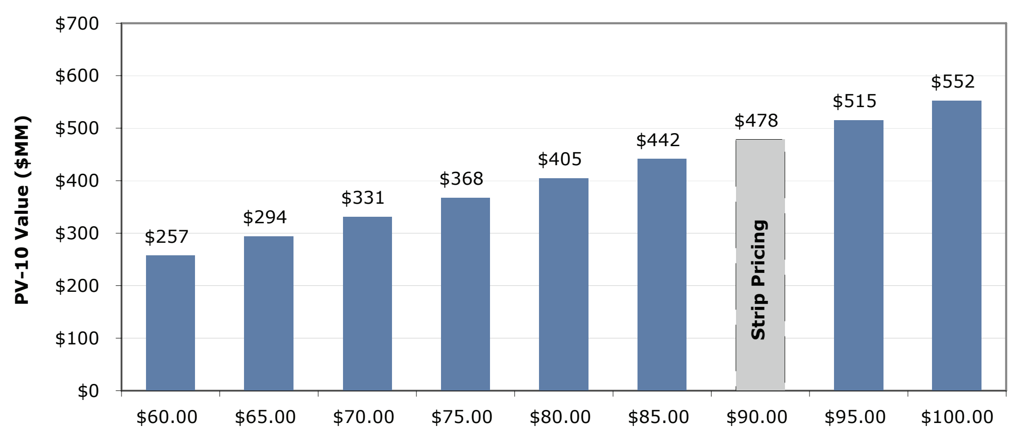
Management listed a number of potential outcomes with respect to its interest in ENP including:

(1) **Merge ENP with another publicly traded MLP.** We believe other upstream MLPs are natural buyers of Encore's assets. ENP holds highly desirable MLP appropriate assets located in the Big Horn Basin in Wyoming and Montana, the Williston Basin in North Dakota and Montana, the Permian Basin in West Texas and New Mexico, and the Arkoma Basin in Arkansas and Oklahoma. ENP has a current enterprise value of $1.0B and trades at an EV/2010E EBITDA multiple of 8.0x. In comparison the upstream MLPs have a median EV of $1.1B and trade at a median multiple of 7.6x. Because several of the upstream MLPs are of similar size (in terms of enterprise value) to ENP, we would expect a stock-for-stock transaction as most likely. We would note, however, that if capital markets remain open; a portion of any potential transaction could be financed in the capital markets. Finally, we note that if Denbury were to acquire the Elk Basin assets in a separate transaction (a distinct possibility), the overall size (i.e. enterprise value) of ENP would decrease, making a possible merger more palatable to a wider range of potential suitors.

(2) **Sell ENP's GP interest to another E&P C-Corp/private equity firm.** An E&P C-Corp with a substantial pool of mature, long-lived reserves could purchase ENP as a financing vehicle to help redeploy capital into capital-intensive shale plays. ENP could serve as an alternative to forming a new MLP, in our view.

(3) **Hold back ENP's Elk Basin assets for cash/unit consideration.** Denbury could potentially look to acquire ENP's Elk basin assets located in the Big Horn Basin in northwestern Wyoming and south central Montana, as these properties contain tertiary recovery potential, which fits within Denbury's strategic operating focus. As of December 31, 2009, the Elk Basin properties had proved reserves of 16.9 MMboe, of which 15.9 MMboe was proved developed and 1.0 MMboe was proved undeveloped. In 2009, total production from the basin averaged 1,478 boe/d, of which approximately 96% was crude oil. We estimate the properties are worth $478MM on a PV-10 basis assuming current strip prices for crude oil and natural gas. This implies a value per flowing barrel of approximately $118,000. To note, the PV-10 value of the Elk Basin reserves as of December 31, 2009, was $264MM. ***Importantly, management indicated that any potential transaction would be made with the goal of preserving ENP's current cash flow and not reducing the partnership's distribution.***

**Figure 3. Net Asset Value (PV-10) Of Elk Basin Reserves**




| Crude Oil Price ($/Bbl) | $60.00 | $65.00 | $70.00 | $75.00 | $80.00 | $85.00 | $90.00 | $95.00 | $100.00 |
|---|---|---|---|---|---|---|---|---|---|
| PV-10 ($MM) | $257 | $294 | $331 | $368 | $405 | $442 | $478 | $515 | $552 |
| EBITDA ($MM) | $50.2 | $56.0 | $61.9 | $67.7 | $73.6 | $79.4 | $85.2 | $91.1 | $96.9 |
| Production (Bbl/d) | 4,049 | 4,049 | 4,049 | 4,049 | 4,049 | 4,049 | 4,049 | 4,049 | 4,049 |
| Cost Per Flowing Barrel | $63,517 | $72,625 | $81,732 | $90,840 | $99,948 | $109,055 | $118,163 | $127,271 | $136,379 |

Source: Partnership reports, FactSet, and Wells Fargo Securities, LLC estimates

**Solid Liquidity**

As of March 31, 2010, ENP had $250MM drawn on its credit facility. The partnership repaid approximately $5MM of debt during Q1 through internally generated cash flow. ENP has approximately $125MM of liquidity available on its $375MM borrowing base (utilization of 67%). The partnership's debt/TTM EBITDA ratio in Q1 2010 was 1.7x, which is well below its maximum permitted covenant of 3.5x. While a budget for the partnership has not yet been finalized, management indicated that capex spending is likely to remain in the $5-6MM range for the year. ENP intends to finance this budget through internally generated cash flow. The partnership does not have any growth capex needs.

**Raising 2010 Estimates--No Change To 2011 Estimates**

We are raising our 2010 DCF per unit estimate to $2.56 from $2.53 primarily to reflect the Q1 variance. There is no change to our 2011 DCF per unit estimate of $2.57 (assumes $100MM of acquisitions).

**Figure 4. Overview Of Changes To Our Estimates**

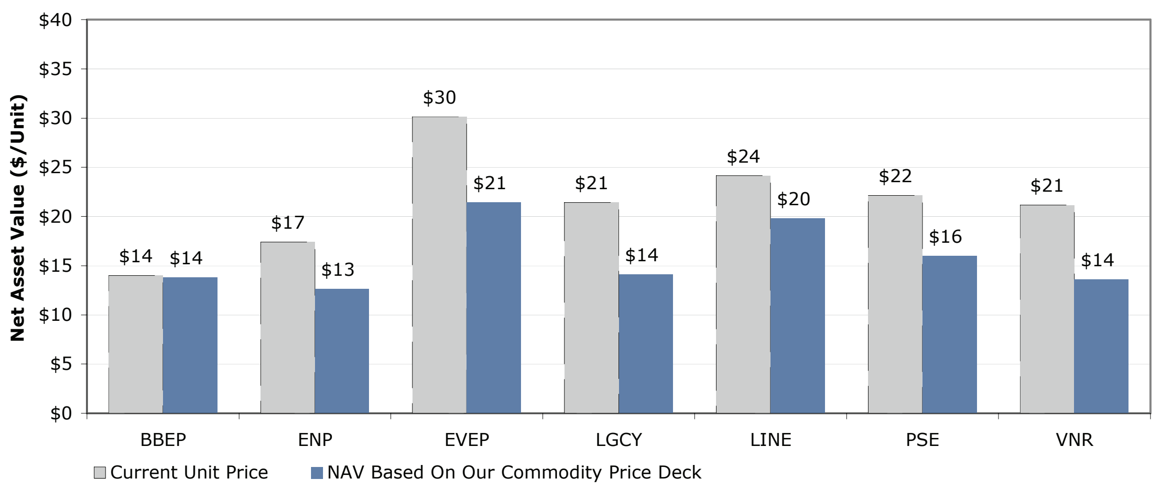
| *($MM, except per unit data)* | Revised 2010E | Previous 2010E | Variance | Revised 2011E | Previous 2011E | Variance |
|---|---|---|---|---|---|---|
| Total production (MBoe) | **3,454** | 3,505 | (1%) | **3,790** | 3,879 | (2%) |
| Net income per unit (EPU) | **$1.30** | $1.30 | 1% | **$1.47** | $1.46 | 1% |
| EBITDA | **$138.6** | $137.8 | 1% | **$156.5** | $156.6 | (0%) |
| Cash interest expense | **$13.1** | $12.5 | 5% | **$14.2** | $14.0 | 2% |
| Maintenance capex | **$5.9** | $6.9 | (15%) | **$15.2** | $15.7 | (3%) |
| DCF per unit | **$2.56** | $2.53 | 1% | **$2.57** | $2.57 | 0% |
| Distribution declared per unit | **$2.04** | $2.04 | (0%) | **$2.04** | $2.04 | 0% |
| Coverage ratio | **1.3x** | 1.2x | 1% | **1.3x** | 1.3x | 0% |
| Acquisition capex | **$100** | $100 | - | **$100** | $100 | - |

Source: Partnership reports, FactSet, and Wells Fargo Securities, LLC estimates

## Maintaining Our Valuation Range Of $21-23 Per Unit.

Our valuation range assumes $100MM annually of acquisition, which seems reasonable, given that a strategic buyer would likely continue the MLP growth via acquisition model. Our valuation range is based on a blend of (1) our three-stage discounted free-cash flow model, which assumes a 11% required rate of return and a long-term growth rate of 0%, and (2) a price-to-distributable cash flow multiple of about 8.5x our 2010 estimate. Risks to the units trading below our range include a dependence on acquisitions to fuel growth and partially offset the depletion of reserves, the inability to hedge at favorable prices, and rising interest rates.

**Figure 5. ENP Versus Upstream MLP Peer Group**




| Ticker | 05/07/10 | Current Yield [1] | EV ($MM) | EV / 2010E EBITDA | EV / 2010E Flowing Mcfe | P / NAV | EV / Mcfe | P / 2010E DCF [2] | Est. 3-Yr Distrib. CAGR |
|---|---|---|---|---|---|---|---|---|---|
| BBEP | $13.99 | 10.7% | $1,295 | 6.4x | $12,087 | 101% | $1.94 | 6.1x | - |
| CEP | $3.39 | 0.0% | $271 | - | - | - | $2.06 | - | - |
| ENP | $17.40 | 11.5% | $1,039 | 8.1x | $19,234 | 137% | $4.02 | 6.8x | (2.4%) |
| EVEP | $30.16 | 10.0% | $1,169 | 7.3x | $15,493 | 141% | $2.63 | 8.5x | 1.7% |
| LGCY | $21.42 | 9.7% | $1,118 | 7.9x | $19,818 | 152% | $4.94 | 8.3x | 2.3% |
| LINE | $24.14 | 10.4% | $5,526 | 7.8x | $20,466 | 122% | $2.56 | 8.4x | 0.0% |
| PSE | $22.15 | 9.0% | $802 | 7.9x | $20,576 | 138% | $3.01 | 9.9x | 1.8% |
| VNR | $21.14 | 9.9% | $642 | 7.4x | $22,599 | 156% | $3.75 | 7.1x | 2.7% |
| **Median** | | **10.0%** | **$1,078** | **7.8x** | **$19,818** | **138%** | **$2.82** | **8.3x** | **1.7%** |
| **Gas-Weighted Median** | | **10.2%** | **$1,169** | **7.4x** | **$17,980** | **131%** | **$2.56** | **7.7x** | **1.7%** |
| **Oil-Weighted Median** | | **9.7%** | **$1,039** | **7.9x** | **$19,818** | **138%** | **$4.02** | **8.3x** | **1.8%** |

Note 1: Excludes MLPs not currently paying a distribution
Note 2: P/DCF multiples include our acquisition assumptions ($50MM for VNR, $100MM for ENP, $150MM for EVEP, $50MM for LGCY, and $500MM for LINE); all other multiples shown above exclude our acquisition assumptions.
Source: Partnership reports, FactSet, and Wells Fargo Securities, LLC estimates

# ENP Earnings Model (Assumes $100MM/Year Of Acquisitions)

## Production And Pricing

| ($ in millions except for per unit data) | FY2009A | 3/31/10A | 6/30/10E | 9/30/10E | 12/31/10E | FY2010E | 3/31/11E | 6/30/11E | 9/30/11E | 12/31/11E | FY2011E | FY2012E | FY2013E | FY2014E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Production Summary:** | | | | | | | | | | | | | | |
| Natural gas production (MMcf) | 5,626 | 1,515 | 1,529 | 1,545 | 1,545 | 6,135 | 1,510 | 1,526 | 1,542 | 1,541 | 6,120 | 6,123 | 6,094 | 6,081 |
| Crude oil production (MBbl) | 1,982 | 561 | 559 | 657 | 655 | 2,432 | 642 | 647 | 741 | 740 | 2,770 | 3,138 | 3,515 | 3,898 |
| NGL production (MBbl) | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **Total Production (MBoe)** | **2,920** | **813** | **814** | **915** | **912** | **3,454** | **894** | **902** | **998** | **997** | **3,790** | **4,159** | **4,531** | **4,912** |
| Daily production (Boe/d) | 7,999 | 9,034 | 8,947 | 9,943 | 9,915 | 9,463 | 9,929 | 9,908 | 10,846 | 10,837 | 10,383 | 11,394 | 12,412 | 13,456 |
| **Our Commodity Price Assumptions:** | | | | | | | | | | | | | | |
| **Natural gas ($/Mcf)** | **$4.09** | **$5.44** | **$4.31** | **$5.13** | **$5.64** | **$5.13** | **$6.16** | **$5.64** | **$6.19** | **$6.62** | **$6.15** | **$6.41** | **$6.41** | **$6.41** |
| **Crude oil ($/Bbl)** | **$61.90** | **$78.88** | **$82.50** | **$83.00** | **$83.60** | **$82.00** | **$87.50** | **$87.50** | **$87.50** | **$87.50** | **$87.50** | **$80.00** | **$80.00** | **$80.00** |
| **Natural gas liquids ($/Bbl)** | **$34.62** | **$49.92** | **$47.85** | **$48.97** | **$50.16** | **$49.22** | **$52.50** | **$52.50** | **$52.50** | **$52.50** | **$52.50** | **$48.00** | **$48.00** | **$48.00** |
| **Realized Prices:** | | | | | | | | | | | | | | |
| Natural gas ($/Mcf) | $6.48 | $7.25 | $7.33 | $7.19 | $7.10 | $7.22 | $5.88 | $5.78 | $5.89 | $6.04 | $5.90 | $5.98 | $6.00 | $6.00 |
| Crude oil ($/Bbl) | $86.04 | $66.89 | $71.83 | $72.33 | $72.65 | $70.92 | $76.50 | $76.50 | $76.69 | $76.68 | $76.59 | $70.91 | $71.40 | $71.40 |

## Income Statement

| ($ in millions except for per unit data) | FY2009A | 3/31/10A | 6/30/10E | 9/30/10E | 12/31/10E | FY2010E | 3/31/11E | 6/30/11E | 9/30/11E | 12/31/11E | FY2011E | FY2012E | FY2013E | FY2014E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Revenues:** | | | | | | | | | | | | | | |
| Natural gas, crude oil, and NGL sales | 133.0 | 48.6 | 47.3 | 56.0 | 56.9 | 208.8 | 58.8 | 58.6 | 66.8 | 67.3 | 251.6 | 260.8 | 287.5 | 314.8 |
| Realized gain / (loss) on derivatives | 70.2 | 1.7 | 4.1 | 2.6 | 1.6 | 10.0 | (1.2) | (0.6) | (1.1) | (1.5) | (4.5) | 0.8 | 1.8 | 1.3 |
| Other, net | (24.1) | (2.4) | (2.4) | (2.4) | (2.4) | (9.6) | (2.4) | (2.4) | (2.4) | (2.4) | (9.7) | 0.3 | 0.3 | 0.3 |
| Net Revenue | $179.1 | $47.9 | $49.0 | $56.2 | $56.1 | $209.2 | $55.2 | $55.6 | $63.2 | $63.4 | $237.4 | $261.9 | $289.6 | $316.4 |
| **Operating Costs and Expense:** | | | | | | | | | | | | | | |
| Lease operating and workover expenses | 33.8 | 11.6 | 11.4 | 12.6 | 12.6 | 48.2 | 12.3 | 12.4 | 13.6 | 13.6 | 52.0 | 56.4 | 60.8 | 65.3 |
| Production taxes and ad valorem | 14.5 | 5.1 | 5.2 | 6.2 | 6.3 | 22.7 | 6.5 | 6.4 | 7.3 | 7.4 | 27.7 | 28.7 | 31.6 | 34.6 |
| General and administrative expenses | 9.4 | 1.9 | 2.3 | 2.6 | 2.6 | 9.4 | 2.6 | 2.6 | 2.9 | 2.9 | 11.2 | 12.6 | 14.1 | 15.8 |
| Depreciation, depletion, and amortization | 49.2 | 12.9 | 12.6 | 14.2 | 14.1 | 53.8 | 13.9 | 14.0 | 15.5 | 15.5 | 58.7 | 64.5 | 70.2 | 76.1 |
| Other operating expenses, net | 6.5 | 0.0 | 0.2 | 0.2 | 0.2 | 0.7 | 0.2 | 0.2 | 0.2 | 0.2 | 0.9 | 0.9 | 0.9 | 0.9 |
| Total Operating Costs And Expenses | 113.4 | 31.4 | 31.8 | 35.8 | 35.8 | 134.9 | 35.5 | 35.7 | 39.6 | 39.6 | 150.5 | 163.1 | 177.7 | 192.8 |
| EBIT (operating income) | 65.7 | 16.5 | 17.2 | 20.4 | 20.2 | 74.3 | 19.7 | 19.8 | 23.6 | 23.7 | 86.9 | 98.8 | 111.9 | 123.6 |
| Interest expense (income) | 11.0 | 3.4 | 2.9 | 3.5 | 3.4 | 13.1 | 3.4 | 3.3 | 3.8 | 3.8 | 14.2 | 24.9 | 26.3 | 27.4 |
| Other expense (income) | (0.0) | 0.0 | (0.0) | (0.0) | (0.0) | 0.0 | (0.0) | 0.0 | (0.0) | (0.0) | (0.0) | (0.0) | 0.0 | 0.0 |
| Recurring net income | $54.8 | $13.1 | $14.3 | $16.9 | $16.8 | $61.2 | $16.4 | $16.5 | $19.8 | $20.0 | $72.7 | $74.0 | $85.5 | $96.2 |
| Non-recurring and non-cash items | (105.1) | 4.3 | 0.0 | 0.0 | 0.0 | 4.3 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Net income per unit (EPU)** | **$1.37** | **$0.29** | **$0.31** | **$0.36** | **$0.35** | **$1.30** | **$0.34** | **$0.34** | **$0.40** | **$0.39** | **$1.47** | **$1.41** | **$1.55** | **$1.66** |
| Total weighted average units outstanding | 39.3 | 45.3 | 45.3 | 46.6 | 47.9 | 46.3 | 47.9 | 47.9 | 49.2 | 50.5 | 48.9 | 51.6 | 54.3 | 57.0 |
| **Adjusted EBITDA** | **$142.7** | **$31.8** | **$32.5** | **$37.3** | **$37.1** | **$138.6** | **$36.3** | **$36.5** | **$41.8** | **$41.9** | **$156.5** | **$164.1** | **$182.9** | **$200.5** |
| Cash interest expense (income) | 10.9 | 3.3 | 2.9 | 3.5 | 3.4 | 13.1 | 3.4 | 3.3 | 3.8 | 3.8 | 14.2 | 24.9 | 26.3 | 27.4 |
| Maintenance capex | 7.1 | 0.5 | 1.6 | 1.9 | 1.9 | 5.9 | 3.5 | 3.5 | 4.1 | 4.1 | 15.2 | 16.4 | 18.3 | 20.1 |
| Other | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Available cash flow | 124.6 | 27.9 | 28.0 | 31.9 | 31.8 | 119.6 | 29.4 | 29.7 | 33.9 | 34.1 | 127.0 | 122.8 | 138.3 | 153.1 |
| Cash paid to general partner | 1.2 | 0.3 | 0.3 | 0.3 | 0.3 | 1.3 | 0.3 | 0.3 | 0.4 | 0.4 | 1.4 | 1.4 | 1.5 | 1.7 |
| Distributable Cash Flow | $123.3 | $27.6 | $27.6 | $31.6 | $31.5 | $118.3 | $29.1 | $29.3 | $33.5 | $33.7 | $125.6 | $121.4 | $136.7 | $151.4 |
| **DCF Per Unit** | **$3.14** | **$0.61** | **$0.61** | **$0.68** | **$0.66** | **$2.56** | **$0.61** | **$0.61** | **$0.68** | **$0.67** | **$2.57** | **$2.35** | **$2.52** | **$2.66** |
| Cash Distribution Declared Per Unit | $2.09 | $0.50 | $0.50 | $0.52 | $0.52 | $2.04 | $0.49 | $0.50 | $0.52 | $0.52 | $2.04 | $1.93 | $2.01 | $2.08 |
| Yr/yr % growth | (13.9%) | 0.0% | (3.1%) | (3.1%) | (3.4%) | (2.4%) | (1.1%) | 0.2% | 0.4% | 1.0% | 0.1% | (5.2%) | 4.2% | 3.5% |
| Coverage Ratio | 1.5x | 1.2x | 1.2x | 1.3x | 1.3x | 1.3x | 1.2x | 1.2x | 1.3x | 1.3x | 1.3x | 1.2x | 1.2x | 1.3x |
| Excess cash flow (deficit) | $34.6 | $4.9 | $5.2 | $6.6 | $6.6 | $23.3 | $5.4 | $5.5 | $7.1 | $7.2 | $25.2 | $21.0 | $26.6 | $31.9 |
| Adjusted DCF per unit [1] | $2.41 | $0.44 | $0.47 | $0.52 | $0.50 | $1.93 | $0.49 | $0.50 | $0.55 | $0.54 | $2.08 | $1.88 | $2.01 | $2.13 |
| **Capital Expenditures:** | | | | | | | | | | | | | | |
| Maintenance capex | 7.1 | 0.5 | 1.6 | 1.9 | 1.9 | 5.9 | 3.5 | 3.5 | 4.1 | 4.1 | 15.2 | 16.4 | 18.3 | 20.1 |
| Growth capex | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Acquisition capex | 243.3 | 0.0 | 0.0 | **100.0** | 0.0 | **100.0** | 0.0 | 0.0 | **100.0** | 0.0 | **100.0** | **100.0** | **100.0** | **100.0** |
| **Total Capex Spending** | $250.4 | $0.5 | $1.6 | $101.9 | $1.9 | $105.9 | $3.5 | $3.5 | $104.1 | $4.1 | $115.2 | $116.4 | $118.3 | $120.1 |

## Operational Summary

| ($ in millions except for per unit data) | FY2009A | 3/31/10A | 6/30/10E | 9/30/10E | 12/31/10E | FY2010E | 3/31/11E | 6/30/11E | 9/30/11E | 12/31/11E | FY2011E | FY2012E | FY2013E | FY2014E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Operating Metrics:** | | | | | | | | | | | | | | |
| LOE and workover expenses per Boe | $11.57 | $14.29 | $14.00 | $13.79 | $13.79 | $13.96 | $13.79 | $13.79 | $13.63 | $13.63 | $13.71 | $13.55 | $13.42 | $13.30 |
| Production taxes as % of revenues | 11.1% | 10.4% | 11.0% | 11.0% | 11.0% | 10.9% | 11.0% | 11.0% | 11.0% | 11.0% | 11.0% | 11.0% | 11.0% | 11.0% |
| Total production costs per Boe | $16.54 | $20.52 | $20.39 | $20.53 | $20.65 | $20.53 | $21.03 | $20.94 | $21.00 | $21.06 | $21.01 | $20.45 | $20.40 | $20.35 |
| G&A per Boe | $3.23 | $2.32 | $2.85 | $2.86 | $2.86 | $2.73 | $2.94 | $2.94 | $2.95 | $2.95 | $2.94 | $3.03 | $3.12 | $3.21 |
| Maintenance capex per Boe | $2.44 | $0.66 | $2.00 | $2.04 | $2.03 | $1.70 | $3.94 | $3.93 | $4.06 | $4.08 | $4.00 | $3.95 | $4.04 | $4.08 |
| Maintenance capex as % of EBITDA | 5% | 2% | 5% | 5% | 5% | 4% | 10% | 10% | 10% | 10% | 10% | 10% | 10% | 10% |
| **Credit Metrics:** | | | | | | | | | | | | | | |
| Equity issuances | $169 | $0 | $0 | $50 | $0 | $50 | $0 | $0 | $50 | $0 | $50 | $50 | $50 | $50 |
| Total debt outstanding (at period end) | $255 | $250 | $245 | $290 | $283 | $283 | $277 | $271 | $316 | $309 | $309 | $436 | $461 | $481 |
| Debt to EBITDA (TTM) | 1.8x | 1.7x | 1.7x | 2.0x | 2.0x | 2.0x | 1.9x | 1.8x | 2.1x | 2.0x | 2.0x | 2.7x | 2.5x | 2.4x |
| EBITDA to interest expense (TTM) | 13.0x | 12.0x | 11.4x | 10.9x | 10.6x | 10.6x | 10.9x | 10.9x | 10.9x | 11.0x | 11.0x | 6.6x | 6.9x | 7.3x |

- Assumed acquisition spending

Note 1: Adjusted DCF per unit assumes 25% of EBITDA is held back for maintenance capex

Source: Partnership reports and Wells Fargo Securities, LLC estimates

## MLP Glossary Of Terms

**Available Cash Flow:** Available cash flow is the cash flow available to the common unitholders and the general partner.

**Backwardation:** A market condition in which future commodity prices are lower than spot prices. A backwardated market usually occurs when demand exceeds supply.

**Contango:** A market condition in which future commodity prices are greater than spot prices. The higher future price is often due to the cost associated with storing and insuring the underlying commodity.

**British Thermal Unit (Btu):** A unit of measurement for energy representing the amount of heat required to raise the temperature of one pound of water one degree Fahrenheit.

**Current Yield:** The current yield is calculated by taking the current declared quarterly distribution annualized and dividing it by current stock price.

**Dekatherm:** A dekatherm is a measurement of energy content. One dekatherm is the approximate energy content of 1,000 cubic feet of natural gas (or 1 Mcf).

**Distributable Cash Flow (DCF):** DCF is the cash flow available to be paid to common unitholders after payments to the general partner.

**Distribution (Dividend) Discount Model (DDM):** DDM is an equity valuation tool used to estimate the present value of a stock based on the expected distributions (or dividends/future cash flow) received from the company.

**Distribution:** In a typical partnership agreement, the MLP is required to distribute all of its "available cash." MLPs typically distribute all available cash flow (i.e. cash flow from operations less maintenance CAPEX) to unitholders in the form of distributions (similar to dividends). However, management typically has some discretion in how much cash flow they choose to pay out.

**Distribution Coverage Ratio:** The coverage ratio indicates the cash available for distribution for every dollar to be distributed. The ratio is calculated by dividing available cash flow by distributions paid. Investors typically associate as the "cushion" a partnership has in paying its cash distribution. In this context, the higher the ratio, the greater the safety of the distribution.

**Dropdown:** A dropdown is the sale of an asset from the parent company (or sponsor company) to the underlying partnership. Dropdowns can also be defined as a transaction between two affiliated companies.

**Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA):** EBITDA is a non-GAAP measure used to provide an approximation of a company's profitability. This measure excludes the potential distortion that accounting and financing rules may have on a company's earnings; therefore, EBITDA is a useful tool when comparing companies that incur large amounts of depreciation expense because it excludes these non-cash items which could understate the company's true performance.

**Earnings Per Unit (EPU):** An MLPs' EPU is synonymous with a C corp.'s earnings per share (EPS). EPU is calculated by dividing net income allocated to the limited partners divided by the weighted average units outstanding at the end of the period.

**EBITDA Multiple:** An EBITDA multiple is the expected return an acquisition or organic growth project is estimated to generate. For example, a $100 million investment at an 8x EBITDA multiple, would be expected to generate approximately $12.5 million of EBITDA on an annual basis (or a 12.5% return).

**Excess Cash Flow:** Excess cash flow is the cash flow that remains after distributions have been paid to common and subordinated unitholders and general partner.

**Fractionation:** Fractionation is the process that involves the separation of the NGLs into discrete NGL purity products (i.e. ethane, propane, normal butane, iso-butane, and natural gasoline).

**Frac Spread (also known as "Processing Margin"):** The processing margin is the difference between the price of natural gas and a composite price for NGLs on a BTU-equivalent basis.

**General Partner (GP):** The GP (1) manages the day-to-day operations of the partnership, (2) generally has a 2% ownership stake in the partnership, and (3) is eligible to receive an incentive distribution (through the ownership of the MLPs' incentive distribution rights).

**Incentive Distribution Rights (IDRs):** IDRs allow the holder (typically the general partner) to receive an increasing percentage of quarterly distributions after the MQD and target distribution thresholds have been achieved. In most partnerships, IDRs can reach a tier wherein the GP is receiving 50% of every incremental dollar paid to the LP unitholders. This is known as the 50/50 or "high splits" tier.

**Limited Partner (LP):** The LP (1) provides capital, (2) has no role in the MLPs' operations or management, and (3) receives cash distributions.

**Maintenance Capital Expenditures (CAPEX):** Maintenance CAPEX is the investment required to maintain the partnership's existing asset.

**Natural Gas Liquids (NGLs):** NGLs are extracted from the raw natural gas stream into a liquid mix (consisting of ethane, propane, butane, iso-butane, and natural gasoline). The NGLs are then typically transported via pipelines to fractionation facilities.

**Net Asset Value (NAV):** We define NAV as the discounted value of future cash flow from the production of a partnership's current reserve base. In our NAV estimates, we have not assumed any additional capex spending (i.e. organic growth or acquisition capex) or credit for any unproved reserves.

**Organic Growth Capital Expenditures (CAPEX):** Organic CAPEX is investments used to expand a company's operating capacity or operating income over the long-term.

**Price Per Flowing Boe/Mcfe:** Price paid per barrel of daily production

**Processing:** Natural gas processing involves the separation of raw natural gas into "pipeline quality" gas and natural gas liquids.

**Proved Developed Producing Reserves (PDP):** PDPs are reserves that can be recovered via existing wells and through the use of existing equipment and operations.

**Proved Undeveloped Reserves (PUDs):** PUDs are reserves that are recovered through new wells (on undrilled acreage) or from existing wells that require significant capital expenditures (to be recompleted).

**PV-10 (Standardized Measure):** PV-10 is the after tax present value of estimated future cash flow of proved reserves. The calculation is based on current commodity prices and is discounted at 10%.

**Recompletion:** A recompletion is the completion of an existing wellbore (i.e. had been previously completed) for production.

**Shale:** Shale is a form of sedimentary rock, which contains crude oil or natural gas.

**Tax Deferral Rate:** A percentage of the cash distribution to the unitholder that is tax deferred until the security is sold. The tax deferral rate on distributions ranges from 40-90%.

**Upstream:** Upstream relates to the production of oil and natural gas from the wellhead (also known exploration and production).

## Energy Industry Abbreviations

**Bbls:** Barrels

**Bcf/d:** One billion cubic feet per day

**MBtu:** One thousand Btus.

**Mcf:** One thousand cubic feet of natural gas.

**MBbls:** One thousand barrels.

**MBbls/d:** One thousand barrels per day.

**MM:** In millions.

**MMBbls:** One million barrels.

**MMBbls/d:** One million barrels per day.

**MMBtu:** One million Btus.

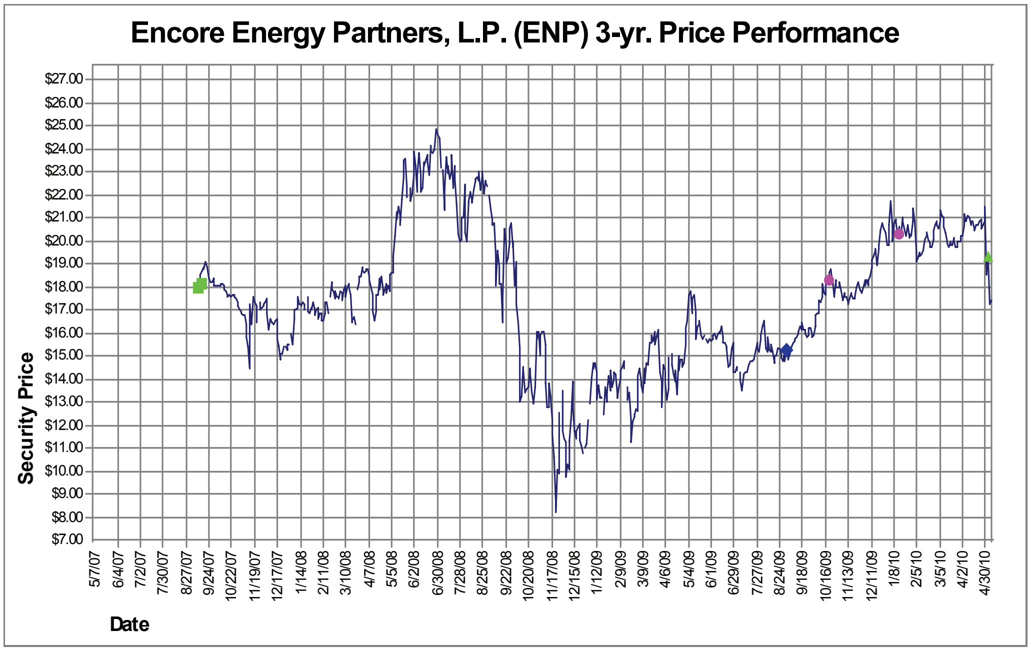
**MMBtu/d:** One million Btus per day.

**MMcf:** One million cubic feet of natural gas.

**MMcf/d:** One million cubic feet of natural gas per day.

**Tcf:** One trillion cubic feet of gas.

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| ❐ | 9/12/2007 | | IPO at $21.00 | | | |
| | 8/30/2009 | | Blum | | | |
| ◆ | 8/31/2009 | 15.14 | 2 | 15.00 | 17.00 | 15.26 |
| ● | 10/21/2009 | 18.32 | 2 | 17.00 | 19.00 | 18.32 |
| ● | 1/15/2010 | 20.60 | 2 | 21.00 | 23.00 | 20.34 |
| ▲ | 5/4/2010 | 18.58 | 1 | 21.00 | 23.00 | 19.35 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- ❐ Split Adjustment

**Rating Code Key**
- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

# Additional Information Available Upon Request

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## STOCK RATING

**1=Outperform:** The stock appears attractively valued, and we believe the stock's total return will exceed that of the market over the next 12 months. BUY
**2=Market Perform:** The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD
**3=Underperform:** The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

## SECTOR RATING

**O=Overweight:** Industry expected to outperform the relevant broad market benchmark over the next 12 months.
**M=Market Weight:** Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.
**U=Underweight:** Industry expected to underperform the relevant broad market benchmark over the next 12 months.

## VOLATILITY RATING

**V** = A stock is defined as volatile if the stock price has fluctuated by +/-20% or greater in at least 8 of the past 24 months or if the analyst expects significant volatility. All IPO stocks are automatically rated volatile within the first 24 months of trading.

As of: May 7, 2010

| | |
|---|---|
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May 7, 2010

WELLS FARGO SECURITIES

# *Equity Research*

## Energy Transfer Partners, L.P.

**ETP: Q1 DCF In Line With Forecast--Lowering Estimates**
**Long-Term Distribution Growth Outlook Intact-Maintain Outperform**

**Outperform**

Sector: Large Cap Pipeline MLPs
Overweight

- **Key Takeaways.** Q1 EBITDA was slightly below our forecast, but DCF was in line. Intrastate volumes increased 6% sequentially due to increased drilling in the Barnett Shale and Bossier Sands. While volumes have subsequently flattened, management is cautiously optimistic that volumes could increase over the course of the year, assuming natural gas prices remain above $3.50 per MMBtu. ETP provided additional transparency around its intrastate pipeline business in its earnings release. We are lowering our 2010 and 2011 DCF per unit estimates to $3.59 and $4.01, respectively, from $3.90 and $4.41 primarily to reflect a recalibration of our margin estimates based on management's additional disclosures. We maintain our Outperform rating. Our long-term distribution growth outlook for ETP remains essentially unchanged. Meanwhile, investors are paid to wait with ETP providing what we see as a secure and robust yield of 8.3%. We anticipate ETP will resume distribution growth in Q1 2011 and increase its distribution by 3-5% annually thereafter supported by improving gas fundamentals and a ramp-up of fee-based cash flow from new growth initiatives.
- **Q1 EBITDA Slightly Below Forecast.** ETP reported Q1 adjusted EBITDA of $454MM, which was below our estimate of $516MM primarily due to higher than forecast noncash losses tied to commodity derivative positions and storage contracts. After adjusting for the aforementioned noncash derivative items, Q1 EBITDA of $506MM was slightly (4.6%) below our estimate of $530MM and compares to consensus of $490MM. The shortfall was primarily due to lower propane results, which more than offset the impact of higher intrastate pipeline results. Intrastate pipeline margin benefited from a larger-than-forecast realized gain on natural gas sold from ETP's Bammel facility.
- **DCF Per Unit In Line.** Q1 2010 DCF per unit of $1.44, which excludes the aforementioned noncash items, was essentially in line with our estimate of $1.49. ETP maintained its quarterly distribution of $0.89375 per unit, which was in line with our expectation. On a TTM basis, ETP generated a coverage ratio of 0.94x (or a slight cash flow deficit of $61MM). We believe it is important to view ETP's coverage on a TTM basis given the high degree of seasonality in propane.

### *Earnings Estimate Revised Down*

| | 2009A | 2010E | | 2011E | |
|---|---|---|---|---|---|
| **DCF/unit** | | **Curr.** | **Prior** | **Curr.** | **Prior** |
| **Q1** (Mar.) | $2.22 | **$1.44 A** | **1.49** | **$1.46** | **1.63** |
| **Q2** (June) | 0.61 | **0.52** | **0.54** | **0.78** | **0.86** |
| **Q3** (Sep.) | 0.38 | **0.51** | **0.55** | **0.63** | **0.69** |
| **Q4** (Dec.) | 0.75 | **1.13** | **1.32** | **1.13** | **1.24** |
| **FY** | $3.87 | **$3.59** | **3.90** | **$4.01** | **4.41** |
| **CY** | $3.87 | $3.59 | | $4.01 | |
| **FY P/DCF** | 11.7x | 12.6x | | 11.3x | |
| **Rev.(MM)** | $5,417 | $8,475 | | $9,620 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

*2009 DCF per unit do not sum to the full-year total due to changes in the share count outstanding.*

| | |
|---|---|
| Ticker | ETP |
| Price (05/07/2010) | $45.10 |
| 52-Week Range: | $37-50 |
| Shares Outstanding: (MM) | 189.1 |
| Market Cap.: (MM) | $8,528.4 |
| S&P 500: | 1,120.79 |
| Avg. Daily Vol.: | 915,310 |
| Dividend/Yield: | $3.58/7.9% |
| LT Debt: (MM) | $6,015.0 |
| LT Debt/Total Cap.: | 54.0% |
| ROE: | NM |
| 3-5 Yr. Est. Growth Rate: | 4.0% |
| CY 2010 Est. P/DCF/unit-to-Growth: | 3.1x |
| Last Reporting Date: | 05/06/2010 Before Open |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

### Valuation Range: $51.00 to $55.00

Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 14.5x our 2010 estimate. Risks to ETP achieving our valuation range include: (1) execution risk related to integrating acquisitions and completing organic growth projects; (2) negative outcome from third-party litigation; (3) competition in the Texas-Louisiana natural gas market; and (4) abnormally warm weather.

### Investment Thesis:

ETP should be able to resume distribution growth in 2011 supported by a ramp-up of fee-based cash flow from new growth initiatives. In the meantime, investors are paid to wait with ETP providing a secure and robust yield of 8%, even given the current weak environment for natural gas fundamentals. About 80% of ETP's distribution is tax deferred.

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**Please see page 9 for rating definitions, important disclosures and required analyst certifications**

## Company Description:

Energy Transfer Partners, L.P., the third-largest energy MLP, is involved in the gathering, treating, processing, transportation, and storage of natural gas. The partnership's assets include approximately 14,600 miles of intrastate pipeline in Texas, 2,700 miles of interstate pipeline (Transwestern), and a 50% joint venture interest in Mid-Continent Express Pipeline. ETP is also the third-largest retail propane distributor in the United States, serving more than 1 million customers in 40 states.

### Q1 Results Mixe--EBITDA Slightly Below Forecast, But DCF In Line

ETP reported Q1 adjusted EBITDA of $454MM, which was below our estimate of $516MM primarily due to higher than forecast noncash losses tied to commodity derivative positions and storage contracts. After adjusting for the aforementioned noncash derivative items, Q1 EBITDA of $506MM was slightly (4.6%) below our estimate of $530MM and compares to consensus of $490MM. The negative variance was primarily driven by lower propane results ($147MM versus our estimate of $201MM and $184MM in Q1 2009), which more than offset higher cash intrastate results ($163MM plus $55MM of noncash items = $218MM versus our estimate of $168MM plus $14MM of noncash items = $182MM).

Q1 2010 DCF per unit of $1.44, which excludes the aforementioned noncash items, was essentially in line with our estimate of $1.49. ETP maintained its quarterly distribution of $0.89375 per unit, which was in line with our expectation. On a TTM basis, ETP generated a coverage ratio of 0.94x (or a slight cash flow deficit of $61MM). As a reminder, we believe it is important to view ETP's coverage on a trailing 12-month (TTM) basis given the high degree of seasonality inherent in the partnership's propane business.

**Figure 6. Q1 2010 Results Versus Our Estimates**

| *($MM, except per unit data)* | Q1'09A | Q4'09A | Q1'10A | Q1'10E | Var ($) | Var (%) |
|---|---|---|---|---|---|---|
| Segment EBITDA | | | | | | |
| Intrastate Pipeline | $168.7 | $245.9 | **$163.2** | $168.4 | ($5.2) | (3.1%) |
| Interstate Pipeline | $39.4 | $70.3 | **$63.0** | $75.5 | ($12.5) | (16.6%) |
| Midstream | $41.6 | $63.2 | **$72.7** | $66.6 | $6.1 | 9.2% |
| Propane | $184.3 | $97.1 | **$146.9** | $200.9 | ($54.0) | (26.9%) |
| Total Segment EBITDA | $434.1 | $476.5 | **$445.7** | $511.3 | ($65.6) | (12.8%) |
| (+) NC compensation expense | $6.8 | $3.1 | **$7.2** | $5.0 | $2.2 | 43.9% |
| (+) Other, net | ($0.1) | ($2.4) | **$1.6** | $0.0 | $1.6 | NM |
| **Total EBITDA** | $440.8 | $477.1 | **$454.4** | $516.3 | ($61.9) | (12.0%) |
| (+) NC commodity deriv. (gain) / loss | $73.2 | ($66.5) | **$59.3** | $13.7 | $45.6 | NM |
| (+) NC lower cost / market (gain) / loss | $21.1 | ($27.3) | **($7.9)** | $0.0 | ($7.9) | NM |
| (+) NC interest rate deriv. (gain) / loss | $0.0 | ($12.4) | **$0.0** | $0.0 | $0.0 | NM |
| **Total EBITDA (adj. for derivatives)** | $535.0 | $371.0 | **$505.9** | $530.0 | ($24.2) | (4.6%) |
| (-) Interest expense | $80.1 | $107.8 | **$102.7** | $105.6 | ($2.9) | (2.7%) |
| (-) Maintenance capex | $14.6 | $30.9 | **$19.6** | $22.6 | ($3.0) | (13.1%) |
| (-) Share of JV DD&A and interest exp. | $0.0 | $12.7 | **$13.4** | $15.5 | ($2.1) | (13.3%) |
| (-) Income tax expense | $0.2 | ($4.1) | **$4.5** | $10.8 | ($6.4) | (58.6%) |
| (+) Distribs. in excess of equity egs. | $0.3 | $8.9 | **$10.1** | $10.6 | ($0.5) | (4.8%) |
| (+) Other, net | $1.1 | ($2.2) | **$1.0** | $0.0 | $1.0 | NM |
| Total Distributable Cash Flow | $347.3 | $336.6 | **$376.8** | $386.2 | ($9.4) | (2.4%) |
| **DCF / Unit** | $2.22 | $0.75 | **$1.44** | $1.49 | ($0.05) | (3.3%) |
| Distribution / Unit | $0.89 | $0.89 | **$0.89** | $0.89 | $0.00 | 0.0% |
| TTM Coverage Ratio | 1.26x | 1.04x | **0.94x** | 0.98x | (0.04x) | (3.9%) |
| TTM Excess Cash Flow | $228.7 | $35.7 | **($60.6)** | ($50.1) | ($10.5) | 20.9% |
| LP Income / Unit (EPU) | $1.37 | $0.91 | **$0.74** | $1.06 | ($0.32) | (30.0%) |
| Average Units Outstanding | 157.4 | 177.2 | **189.1** | 189.4 | (0.3) | (0.1%) |

Source: Partnership reports and Wells Fargo Securities, LLC estimates

### Intrastate Pipeline (Beat)

Intrastate pipeline EBITDA of $225MM was slightly below our forecast primarily due to higher noncash derivative losses ($55.4MM versus our estimate of $13.7MM). On a cash basis, intrastate EBITDA totaled $219MM, which was well above our estimate of $182MM. The variance was primarily due to higher-than-forecast realized storage gains. Notably, ETP withdrew and sold 27 Bcf of natural gas from its Bammel storage facility for a realized margin of $2.48 per Mcf versus our estimate of $1.16 per Mcf. Intrastate pipeline volumes of 11,354 BBtu/d were in line with our forecast of 11,665 BBtu/d, but 21.3% below Q1 2009 levels. The year/year decrease in volumes is primarily attributable to narrowing basis differentials between west and east market hubs in Texas.

For the first time, ETP disclosed the portion of intrastate gross margin derived from transportation fees ($141MM versus our previous estimate of $155MM), storage margin ($64MM on a cash basis versus our estimate of $39MM), fuel retention revenue ($36MM versus our estimate of $50MM), and marketing ($40MM versus our estimate of $3MM). We are recalibrating our margin estimates accordingly to reflect the additional disclosure.

*Outlook For 2010:* During the earnings conference call, management that volumes increased by 600 MMcf/d in Q1 2010 relative to Q4 2009, but have now showed signs of flattening. Notwithstanding, management is cautiously optimistic that Barnett Shale volumes will continue to ramp up over the course of the year if natural gas prices remain above approximately $3.50 per MMBtu. To note, ETP entered into additional derivative contracts to hedge substantially all of its expected natural gas price exposure (fuel retention and residue POP contracts in the Midstream business) in 2010 at an average price of $5.80 per MMBtu and 85% of 2011 exposure at a floor of $5.50 per MMBtu and a ceiling of $7.00 per MMBtu

**Figure 7. Overview Of Q1 2010 Intrastate Pipeline Results**

| *($MM, except per unit data)* | Q1'09A | Q4'09A | Q1'10A | Q1'10E | Var (%) | Seq (%) | Yr/Yr (%) |
|---|---|---|---|---|---|---|---|
| *Operating Metrics:* | | | | | | | |
| Natural gas - transported (BBtu/d) | 13,623 | 10,726 | **11,354** | 11,665 | (2.7%) | 5.9% | (21.3%) |
| Natural gas - sold (BBtu/d) | 1,352 | 1,236 | **1,445** | 1,242 | 16.3% | 16.9% | (8.6%) |
| Total volumes (BBtu/d) | 14,975 | 11,962 | **12,799** | 12,907 | (0.8%) | 7.0% | (20.1%) |
| *Summary Of Segment Earnings:* | | | | | | | |
| Transportation fees | $175.1 | - | **$140.8** | $154.9 | (9.1%) | - | - |
| Storage margin (incl. hedges) | $17.0 | - | **$8.5** | $24.9 | (66.0%) | - | - |
| Fuel retention fees (incl. hedges) | $35.2 | - | **$35.7** | $50.1 | (28.7%) | - | - |
| Marketing margin (incl. hedges) | $18.7 | - | **$40.0** | $2.8 | - | - | - |
| Total Gross Margin | $246.0 | $304.4 | **$225.0** | **$232.7** | (3.3%) | (26.1%) | 23.7% |
| Operating costs | $53.5 | $44.3 | **$42.0** | $50.0 | (16.0%) | (5.4%) | (17.1%) |
| DD&A expense | $25.0 | $29.5 | **$29.0** | $30.3 | (4.2%) | (1.8%) | 17.9% |
| SG&A expense | $23.8 | $14.2 | **$19.8** | $14.3 | 38.7% | 40.0% | (40.5%) |
| Operating Income | $143.7 | $216.4 | **$134.2** | $138.2 | (2.9%) | (38.0%) | 50.5% |
| Equity earnings from investments | $0.0 | $0.0 | **$0.0** | $0.0 | - | - | - |
| EBITDA | $168.7 | $245.9 | **$163.2** | $168.4 | (3.1%) | (33.6%) | 45.7% |
| Non-cash items | $144.5 | ($80.9) | **$55.4** | $13.7 | - | - | - |
| Cash EBITDA | $313.3 | $165.0 | **$218.6** | $182.2 | 20.0% | 32.5% | (47.3%) |

Source: Partnership reports and Wells Fargo Securities, LLC estimates

### Interstate Pipeline (Miss)

Interstate pipeline EBITDA of $63.0MM was below our estimate of $75.5MM primarily due to the combination of higher operating expenses ($16.1MM versus our estimate of $13.8MM), SG&A expense ($8.2MM versus our estimate of $5.2MM), and lower contributions from joint venture investments. EBITDA from joint ventures (i.e. equity in earnings plus proportionate share of interest and DD&A) of $18.9MM was below our estimate of $25.6MM. Total natural gas transportation and sales volumes of 1,578 BBtu/d was slightly below our forecast of 1,623 BBtu/d.

*Outlook For 2010:* In 2010, ETP should benefit from a full-year contribution from MEP (i.e. estimated EBITDA, equity in earnings, and distribution contributions of $102MM, $42MM, and $62MM, respectively, in 2010). We calculate segment EBITDA could increase to $317MM in 2010 from $230MM in 2009.

**Figure 8. Overview Of Q1 2010 Interstate Pipeline Results**

| *($MM, except per unit data)* | Q1'09A | Q4'09A | Q1'10A | Q1'10E | Var (%) | Seq (%) | Yr/Yr (%) |
|---|---|---|---|---|---|---|---|
| *Operating Metrics:* | | | | | | | |
| Natural gas - transported (BBtu/d) | 1,748 | 1,530 | **1,558** | 1,602 | (2.8%) | 1.8% | (10.9%) |
| Natural gas - sold (BBtu/d) | 20.6 | 15.7 | **20.0** | 21.1 | (5.1%) | 27.5% | (2.7%) |
| Total volumes (BBtu/d) | 1,768 | 1,546 | **1,578** | 1,623 | (2.8%) | 2.1% | (10.8%) |
| | | | | | | | |
| *Summary Of Segment Earnings:* | | | | | | | |
| Total Gross Margin | $61.3 | $66.9 | **$68.3** | $68.9 | (0.9%) | 2.1% | 11.3% |
| Operating costs | $15.4 | $12.9 | **$16.1** | $13.8 | 16.6% | 24.3% | 4.5% |
| DD&A expense | $10.7 | $12.3 | **$12.5** | $12.3 | 1.4% | 1.4% | 16.8% |
| SG&A expense | $7.1 | $5.2 | **$8.2** | $5.2 | 56.9% | 57.2% | 14.4% |
| Operating Income | $28.2 | $36.5 | **$31.6** | $37.6 | (16.0%) | (13.4%) | 12.1% |
| Equity earnings from investments | $0.5 | $8.8 | **$5.5** | $10.0 | (45.7%) | (38.3%) | - |
| Share of JV interest and DD&A | $0.0 | $12.7 | **$13.4** | $15.5 | (13.3%) | 6.0% | - |
| EBITDA | $39.4 | $70.3 | **$63.0** | $75.5 | (16.6%) | (10.4%) | 60.0% |

Source: Partnership reports and Wells Fargo Securities, LLC estimates

### Midstream (Beat)

Midstream EBITDA of $72.7MM was above our estimate of $66.6MM. The variance was driven primarily by higher gross NGL production (i.e. 48.3 MBbls/d versus our estimate of 34.6 MBbls/d and 40.2 MBbls/d in Q1 2009). According to our calculations, approximately 60% of ETP's processing volumes are based on fee-based contracts (primarily at the Godley processing facility in north Texas), with the remainder of contracts split between POP (about 5-10%) and keep whole (30-35%).

*Outlook For 2010:* We estimate midstream EBITDA could increase to $306MM in 2010 from $212MM in 2009. The year/year increase in cash flow is based on our higher NGL volumes and processing margin. Management indicated that producers are continuing to focus investments on areas rich in NGLs, which should benefit utilization across ETP's processing plants. For 2010, we assume an NGL price of $1.17 per gallon in 2010 and processing margin of $0.72 per gallon, which compares to $0.82 per gallon and $0.47 per gallon, respectively, in 2009.

**Figure 9. Overview Of Q1 2010 Midstream Results**

| **Midstream** *($MM, except per unit data)* | Q1'09A | Q4'09A | Q1'10A | Q1'10E | Var (%) | Seq (%) | Yr/Yr (%) |
|---|---|---|---|---|---|---|---|
| *Operating Metrics:* | | | | | | | |
| Natural gas - sold (BBtu/d) | 1,091 | 1,291 | **698** | 1,265 | (44.9%) | (46.0%) | (36.1%) |
| NGLs sold (MBbls/d) | 40.2 | 35.3 | **48.3** | 34.6 | 39.8% | 37.0% | 20.1% |
| | | | | | | | |
| *Summary Of Segment Earnings:* | | | | | | | |
| Fee-based margin | $47.9 | - | **$54.3** | $43.5 | 24.7% | - | 13.3% |
| Commodity margin | $24.5 | - | **$42.7** | $45.1 | (5.3%) | - | 73.9% |
| Total Gross Margin | $72.5 | $84.4 | **$97.0** | $88.6 | 9.4% | 14.8% | 33.8% |
| Operating costs | $17.8 | $18.1 | **$17.8** | $17.1 | 4.4% | (1.7%) | 0.2% |
| DD&A expense | $16.5 | $19.1 | **$20.3** | $19.1 | 6.7% | 6.7% | 23.2% |
| SG&A expense | $13.0 | $3.1 | **$6.5** | $5.0 | 29.6% | - | (50.2%) |
| Operating Income | $25.1 | $44.1 | **$52.3** | $47.5 | 10.2% | 18.6% | - |
| Equity earnings from investments | $0.0 | $0.0 | **$0.0** | $0.0 | - | - | - |
| EBITDA | $41.6 | $63.2 | **$72.7** | $66.6 | 9.2% | 15.0% | 74.5% |

Source: Partnership reports and Wells Fargo Securities, LLC estimates

### Propane (Miss)

Propane EBITDA of $146.9MM was below our forecast of $200.9MM and Q1 2009 of $184.3MM. Retail propane volumes of 217.6MM were slightly below our estimate of 229.4MM and essentially flat with Q1 2009. However margins were well below our forecast ($251MM versus our estimate of $308MM).

**Figure 10. Overview Of Q1 2010 Propane Results**

| *($MM, except per unit data)* | Q1'09A | Q4'09A | Q1'10A | Q1'10E | Var (%) | Seq (%) | Yr/Yr (%) |
|---|---|---|---|---|---|---|---|
| *Operating Metrics:* | | | | | | | |
| Total retail propane gallon sold (MM) | 218.5 | 170.1 | **217.6** | 229.4 | (5.1%) | 27.9% | (0.4%) |
| *Summary Of Segment Earnings:* | | | | | | | |
| Total Gross Margin | $290.8 | $187.1 | **$251.4** | $307.6 | (18.3%) | 34.3% | (13.6%) |
| Operating costs | $94.2 | $82.2 | **$91.7** | $98.9 | (7.2%) | 11.6% | (2.6%) |
| DD&A expense | $20.3 | $20.0 | **$20.1** | $20.2 | (0.4%) | 0.4% | (0.9%) |
| SG&A expense | $12.3 | $7.8 | **$12.8** | $7.9 | 63.1% | 63.9% | 4.2% |
| Operating Income | $164.1 | $77.2 | **$126.8** | $180.7 | (29.8%) | 64.3% | (22.7%) |
| Equity earnings from investments | $0.0 | $0.0 | **$0.0** | $0.0 | - | - | - |
| EBITDA | $184.3 | $97.1 | **$146.9** | $200.9 | (26.9%) | 51.2% | (20.3%) |

Source: Partnership reports and Wells Fargo Securities, LLC estimates

## Additional Equity Possible To Improve Leverage

In January, ETP completed a 9.775MM unit offering for total net proceeds of approximately $424MM. As of March 31, 2010, the partnership had approximately $1.94B of liquidity (including cash on hand), which is more than sufficient to cover remaining 2010 capex spending of $1.4B. To note, ETP indicated that costs on expansion projects are coming in lower than originally forecast (Fayetteville Express Pipeline now estimated to cost $1.125B on a gross basis versus $1.250B previously; Tiger Pipeline excluding compression now estimated to cost $1.095-1.100B versus $1.165B previously).

While our model does not assume ETP will issue any additional equity via public secondary offerings this year, we assume the partnership raises $200MM through its $300MM at-the-market program (i.e. allows ETP to issue small tranches of equity from time-to-time in the course of ordinary daily trading volume). To note, ETP raised $81MM through the program in Q1 2010. Notwithstanding, an additional public secondary offering is possible in 2010, in our view.

For 2010, we forecast a pro forma debt/EBITDA ratio of 4.5x. However, leverage should improve in 2011 (estimated of 4.3x) and 2012 (estimated of 4.0x) as ETP receives the cash flow benefit of new projects being placed into service. To note, management previously indicated that ETP's rating agencies do not allow for pro forma EBITDA credit for projects under construction.

**Figure 11. Overview Of 2010 Financing**

| Breakdown Of 2010 Capex ($MM) | |
|---|---|
| Growth Capex Spending (E) | $1,354 |
| Equity Contributions To MEP & FEP (E) | $88 |
| **Total Growth Capex** | **$1,441** |
| **Total Debt Maturities** | **$0** |
| **Total Estimated Capital Requirements** | **$1,441** |

| Breakdown Of 2010 Funding ($MM) | |
|---|---|
| $2B Revolving Credit Facility (E) | $815 |
| **Total Debt Funding** | **$815** |
| Jan 10 Equity Offering (A) | $424 |
| $300MM At-The-Market Program (E) | $200 |
| 2010E Excess Cash Flow (E) | $2 |
| **Total Equity Funding** | **$626** |
| **Total Estimated Funding** | **$1,441** |

| | |
|---|---|
| **GAAP Debt / EBITDA** | **4.5x** |
| **Pro Forma Debt / EBITDA** | **4.5x** |

| Pro Forma 2010E Debt To EBITDA Calculation | |
|---|---|
| **Step 1: Pro Forma Debt Calculation** | *($MM)* |
| Estimated debt outstanding at 12/31/10 | $7,262 |
| Plus: ETP's interest in debt at MEP & FEP | $381 |
| **Pro Forma 2010E Debt Outstanding** | **$7,643** |
| **Step 2: Pro Forma EBITDA Calculation** | *($MM)* |
| 2010E adjusted EBITDA | $1,618 |
| Plus: Non-cash adjustments | $51 |
| Plus: Distribs. in excess of earnings | $25 |
| **Pro Forma 2010E EBITDA** | **$1,695** |
| **Pro Forma Debt To EBITDA** | **4.5x** |

Source: Partnership reports and Wells Fargo Securities, LLC estimates

**Lowering Estimates**

We are lowering our estimates to reflect the net effect of the following adjustments to our model: (1) a recalibration of segment margin within the intrastate business based on management's additional disclosures, (2) lower maintenance capex spending per management's guidance ($70-90MM over the balance of the year or $90-110MM for 2010), (3) lower propane estimates based on Q1 2010 actual results, (4) a higher mix of fee-based processing in ETP's midstream segment based on management's additional disclosures, and (5) lower assumed intrastate pipeline transportation volumes (i.e. 2010 volumes flat with 2009). We are lowering our 2010 and 2011 DCF per unit estimates to $3.59 and $4.01, respectively, from $3.90 and $4.41 previously.

**Figure 12. Overview Of Changes To Our Estimates**

| | New 2010E | Old 2010E | Percent Variance | New 2011E | Old 2011E | Percent Variance |
|---|---|---|---|---|---|---|
| Crude Oil - WTI ($/Bbl) | **$82.00** | $82.00 | 0.0% | **$87.50** | $87.50 | 0.0% |
| Natural Gas - Henry Hub ($/Mcf) | **$5.13** | $5.13 | 0.0% | **$6.15** | $6.15 | 0.0% |
| Natural Gas Liquids ($/Bbl) | **$49.22** | $49.22 | 0.0% | **$52.50** | $52.50 | 0.0% |
| Earnings per unit (EPU) | **$2.04** | $2.74 | (25.4%) | **$2.63** | $3.26 | (19.3%) |
| Intrastate Pipeline | **$700.8** | $793.0 | (11.6%) | **$760.1** | $867.0 | (12.3%) |
| Interstate Pipeline | **$317.2** | $338.7 | (6.3%) | **$478.7** | $490.8 | (2.5%) |
| Midstream | **$307.1** | $271.2 | 13.2% | **$319.5** | $285.9 | 11.8% |
| Propane | **$265.1** | $323.5 | (18.0%) | **$311.7** | $330.8 | (5.8%) |
| Other | **$28.3** | $20.0 | 41.3% | **$26.0** | $20.0 | 30.0% |
| Total EBITDA | **$1,618.4** | $1,746.4 | (7.3%) | **$1,896.0** | $1,994.5 | (4.9%) |
| Non-cash items | **$51.4** | $13.7 | - | **$0.0** | $0.0 | - |
| Cash EBITDA | **$1,669.9** | **$1,760.2** | (5.1%) | **$1,896.0** | **$1,994.5** | (4.9%) |
| Maintenance capex | **$97.1** | $120.5 | (19.4%) | **$132.7** | $169.5 | (21.7%) |
| Interest expense | **$423.8** | $426.4 | (0.6%) | **$501.6** | $487.5 | 2.9% |
| DCF Per Unit | **$3.59** | **$3.90** | (7.8%) | **$4.01** | **$4.41** | (9.2%) |
| Distribution Declared Per Unit | **$3.58** | $3.58 | 0.0% | **$3.69** | $3.69 | 0.0% |
| Distribution Coverage | **1.00x** | 1.06x | (5.1%) | **1.05x** | 1.12x | (6.0%) |
| Excess Cash Flow (Deficit) | **$2.0** | $61.2 | - | **$61.2** | $139.6 | - |

Source: Wells Fargo Securities, LLC estimates

**No Change To Valuation Range Of $51-55 Per Unit**

Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 14.5x our 2010 estimate. Risks to ETP achieving our valuation range include: (1) execution risk related to integrating acquisitions and completing organic growth projects; (2) negative outcome from third-party litigation; (3) competition in the Texas-Louisiana natural gas market; and (4) abnormally warm weather.

ETP yields 7.9% and trades at 2010E and 2011E price-to-distributable cash flow multiples of 12.7x and 11.4x, respectively. This compares to large-cap pipeline MLP peer group medians of 6.9%, 12.6x, and 12.0x, respectively. The partnership's 2010 and three-year distribution growth rate estimates are 0.0% and 2.9%, respectively, as compared to peer group medians of 4.3% and 5.1%.

**Figure 13. ETP Versus Large Cap Pipeline MLP Median**

| | Price | Current | Price/DCF | | Distrib. Growth Est. | | P/DCF To |
|---|---|---|---|---|---|---|---|
| | Current | Yield | 2010E | 2011E | 2010E | 3-Year | Growth Ratio |
| Energy Transfer Partners, LP | $45.49 | 7.9% | 12.7x | 11.4x | 0.0% | 2.9% | 3.9x |
| Large Cap Pipeline MLP Median | | 6.9% | 12.6x | 12.0x | 4.5% | 5.1% | 2.4x |

Note: PEG is based on P/2010E DCF multiple divided by estimated 3-year distribution growth rate
Source: FactSet and Wells Fargo Securities, LLC estimates; pricing intraday 5/7/10

**Energy Transfer Partners, L.P.**

Year ended December 31
($ in millions, except for per unit data)

| Commodity Assumptions | FY2009A | *Q1'10A* | *Q2'10E* | *Q3'10E* | *Q4'10E* | FY2010E | *Q1'11E* | *Q2'11E* | *Q3'11E* | *Q4'11E* | FY2011E | FY2012E | FY2013E | FY2014E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Natural Gas - Henry Hub ($/Mcf) | $4.09 | $5.44 | $4.31 | $5.13 | $5.64 | $5.13 | $6.16 | $5.64 | $6.19 | $6.62 | $6.15 | $6.41 | $6.41 | $6.41 |
| Crude Oil - WTI ($/Bbl) | $61.84 | $78.88 | $82.50 | $83.00 | $83.60 | $82.00 | $87.50 | $87.50 | $87.50 | $87.50 | $87.50 | $80.00 | $80.00 | $80.00 |
| Natural Gas Liquids ($/Bbl) | $34.60 | $49.92 | $47.85 | $48.97 | $50.16 | $49.22 | $52.50 | $52.50 | $52.50 | $52.50 | $52.50 | $48.00 | $48.00 | $48.00 |
| NGL-To-Crude Oil Ratio | 56% | 63% | 58% | 59% | 60% | 60% | 60% | 60% | 60% | 60% | 60% | 60% | 60% | 60% |
| **Summary Income Statement** | | | | | | | | | | | | | | |
| Intrastate Pipelines | 734.4 | 163.2 | 153.1 | 191.2 | 193.2 | 700.8 | 179.4 | 170.1 | 207.2 | 203.3 | 760.1 | 834.7 | 883.2 | 921.9 |
| Interstate Pipelines | 229.5 | 63.0 | 78.9 | 85.2 | 90.2 | 317.2 | 101.3 | 116.8 | 125.8 | 134.8 | 478.7 | 608.7 | 623.9 | 627.8 |
| Midstream | 211.6 | 72.7 | 77.3 | 78.4 | 78.7 | 307.1 | 78.1 | 81.6 | 80.6 | 79.2 | 319.5 | 293.4 | 293.3 | 293.3 |
| Propane | 312.7 | 146.9 | 24.5 | 4.3 | 89.4 | 265.1 | 188.2 | 25.7 | 4.7 | 93.2 | 311.7 | 317.9 | 324.3 | 330.8 |
| Total Segment EBITDA | 1,488.1 | 445.7 | 333.8 | 359.1 | 451.6 | 1,590.2 | 547.0 | 394.1 | 418.3 | 510.5 | 1,870.0 | 2,054.7 | 2,124.7 | 2,173.8 |
| (+) Non-cash G&A expenses | 24.0 | 7.2 | 6.5 | 6.5 | 6.5 | 26.7 | 6.5 | 6.5 | 6.5 | 6.5 | 26.0 | 26.0 | 26.0 | 26.0 |
| (+) Other adjustments, net | (4.8) | 1.6 | - | - | - | 1.6 | - | - | - | - | - | - | - | - |
| **Total EBITDA** | **1,507.4** | **454.4** | **340.3** | **365.6** | **458.1** | **1,618.4** | **553.5** | **400.6** | **424.8** | **517.0** | **1,896.0** | **2,080.7** | **2,150.7** | **2,199.8** |
| Cash EBITDA | 1,541.2 | 505.9 | 340.3 | 344.0 | 479.7 | 1,669.9 | 553.5 | 414.1 | 410.5 | 517.8 | 1,896.0 | 2,080.7 | 2,150.7 | 2,199.8 |
| Net income | 791.5 | 240.1 | 135.2 | 163.8 | 252.8 | 791.9 | 332.4 | 163.7 | 177.3 | 262.9 | 936.3 | 1,059.0 | 1,113.3 | 1,149.8 |
| **EPU** | **$2.53** | **$0.74** | **$0.19** | **$0.33** | **$0.78** | **$2.04** | **$1.17** | **$0.31** | **$0.37** | **$0.78** | **$2.63** | **$3.06** | **$3.16** | **$3.17** |
| Average Units Outstanding | 167.7 | 189.1 | 192.2 | 193.4 | 193.8 | 192.1 | 193.8 | 193.8 | 193.8 | 193.8 | 193.8 | 193.8 | 193.8 | 193.8 |
| **Distributable Cash Flow (DCF)** | | | | | | | | | | | | | | |
| Adjusted EBITDA | 1,507.4 | 454.4 | 340.3 | 365.6 | 458.1 | 1,618.4 | 553.5 | 400.6 | 424.8 | 517.0 | 1,896.0 | 2,080.7 | 2,150.7 | 2,199.8 |
| (-) Interest expense, net | 394.3 | 102.7 | 106.2 | 106.9 | 108.0 | 426.1 | 119.1 | 122.8 | 129.2 | 130.5 | 501.6 | 525.3 | 534.6 | 540.9 |
| (-) Maintenance capex | 102.5 | 19.6 | 20.0 | 25.0 | 32.5 | 97.1 | 24.9 | 24.9 | 41.5 | 41.5 | 132.7 | 156.1 | 172.1 | 176.0 |
| (-) Income tax expense | 3.8 | 4.5 | 0.3 | (1.0) | 4.2 | 7.9 | 10.1 | 0.3 | (1.0) | 4.4 | 13.8 | 14.1 | 14.3 | 14.6 |
| (-) Non-cash derivative gains/(losses) | (30.7) | (59.3) | - | 21.6 | (21.6) | (59.3) | - | (13.5) | 14.3 | (0.8) | (0.0) | - | - | - |
| (-) Lower of cost or market gains/(losses) | (3.2) | 7.9 | - | - | - | 7.9 | - | - | - | - | - | - | - | - |
| (-) JV DD&A and interest expense | 22.3 | 13.4 | 15.1 | 15.3 | 15.5 | 59.3 | 15.5 | 15.5 | 15.5 | 15.5 | 62.0 | 62.0 | 62.0 | 62.0 |
| (+) JV distribs in excess of earnings | 3.2 | 10.1 | 5.1 | 5.1 | 5.1 | 25.4 | 6.9 | 8.7 | 8.7 | 8.7 | 32.9 | 34.7 | 34.7 | 34.7 |
| (+) Other adjustments, net | 0.2 | 1.0 | - | - | - | 3.3 | - | - | - | - | - | - | - | - |
| Available Cash Flow | 1,021.8 | 376.8 | 203.9 | 202.9 | 324.6 | 1,108.2 | 390.8 | 259.4 | 234.0 | 334.7 | 1,218.9 | 1,358.0 | 1,402.4 | 1,441.0 |
| (-) Cash paid to GP | 360.7 | 100.5 | 101.1 | 101.7 | 101.9 | 405.2 | 103.9 | 105.8 | 108.7 | 111.6 | 430.1 | 470.3 | 505.7 | 539.6 |
| (-) Cash paid to class E units | 12.5 | 3.1 | 3.1 | 3.1 | 3.1 | 12.5 | 3.1 | 3.1 | 3.1 | 3.1 | 12.5 | 12.5 | 12.5 | 12.5 |
| Distributable Cash Flow | 648.6 | 273.2 | 99.7 | 98.0 | 219.6 | 690.5 | 283.8 | 150.4 | 122.1 | 219.9 | 776.3 | 875.2 | 884.2 | 888.9 |
| **DCF Per Unit** | **$3.87** | **$1.44** | **$0.52** | **$0.51** | **$1.13** | **$3.59** | **$1.46** | **$0.78** | **$0.63** | **$1.13** | **$4.01** | **$4.52** | **$4.56** | **$4.59** |
| **Cash Distribution Declared Per Unit** | **$3.58** | **$0.89** | **$0.89** | **$0.89** | **$0.89** | **$3.58** | **$0.90** | **$0.91** | **$0.93** | **$0.94** | **$3.69** | **$3.90** | **$4.08** | **$4.26** |
| *Yr/Yr % Change* | *0.7%* | *0.0%* | *0.0%* | *0.0%* | *0.0%* | *0.0%* | *1.1%* | *2.2%* | *3.9%* | *5.6%* | *3.2%* | *5.6%* | *4.7%* | *4.3%* |
| Distribution Coverage | 1.04x | 1.37x | 0.74x | 0.73x | 1.17x | 1.00x | 1.39x | 0.91x | 0.80x | 1.12x | 1.05x | 1.10x | 1.07x | 1.05x |
| Excess Cash Flow (Deficit) | 35.7 | 102.5 | (72.0) | (74.8) | 46.3 | 2.0 | 108.7 | (26.7) | (57.9) | 37.0 | 61.2 | 119.9 | 93.5 | 64.3 |
| **Capital Expenditures** | | | | | | | | | | | | | | |
| Maintenance Capex | 102.5 | 19.6 | 20.0 | 25.0 | 32.5 | 97.1 | 24.9 | 24.9 | 41.5 | 41.5 | 132.7 | 156.1 | 172.1 | 176.0 |
| Acquisition Capex | - | 150.0 | - | - | - | 150.0 | - | - | - | - | - | - | - | - |
| Growth Capex | 602.2 | 122.3 | 410.5 | 410.5 | 410.5 | 1,353.8 | 349.3 | 50.0 | 50.0 | 50.0 | 499.3 | 200.0 | 200.0 | 200.0 |
| Contributions to equity investments | 590.3 | - | 62.7 | 25.0 | - | 87.7 | 281.3 | - | - | - | 281.3 | - | - | - |
| **Total Capex** | **1,295.0** | **291.9** | **493.2** | **460.5** | **443.0** | **1,688.6** | **655.4** | **74.9** | **91.5** | **91.5** | **913.2** | **356.1** | **372.1** | **376.0** |
| **Financing & Credit Metrics** | | | | | | | | | | | | | | |
| Equity Issuance Via Secondaries | 869.0 | 424.0 | - | - | - | 424.0 | - | - | - | - | - | - | - | - |
| Equity Issuance Via At Market Program [1] | 81.5 | 81.0 | 50.0 | 50.0 | 19.0 | 200.0 | - | - | - | - | - | - | - | - |
| Total Debt Outstanding | 6,218 | 6,015 | 6,336 | 6,793 | 7,262 | 7,262 | 7,846 | 7,787 | 7,874 | 7,985 | 7,985 | 8,098 | 8,236 | 8,428 |
| GAAP Debt / EBITDA (TTM) | 4.1x | 4.0x | 4.1x | 4.1x | 4.5x | 4.5x | 4.6x | 4.4x | 4.3x | 4.2x | 4.2x | 3.9x | 3.8x | 3.8x |
| Total Debt Incl. ETP Share Of NR Debt At JVs | 6,409 | 6,215 | 6,611 | 7,128 | 7,643 | 7,643 | 8,227 | 8,169 | 8,256 | 8,366 | 8,366 | 8,479 | 8,617 | 8,809 |
| **Pro Forma Debt / EBITDA (TTM)** | **4.2x** | | | | | **4.5x** | **4.8x** | **4.6x** | **4.5x** | **4.3x** | **4.3x** | **4.0x** | **3.9x** | **3.9x** |

Note 1: Equity raised through at-the-market equity distribution program
Source: Partnership reports and Wells Fargo Securities, LLC estimates

## MLP Glossary Of Terms

**Available Cash Flow:** Available cash flow is the cash flow available to the common unitholders and the general partner.

**Backwardation:** A market condition in which future commodity prices are lower than spot prices. A backwardated market usually occurs when demand exceeds supply.

**Contango:** A market condition in which future commodity prices are greater than spot prices. The higher future price is often due to the cost associated with storing and insuring the underlying commodity.

**British Thermal Unit (Btu):** A unit of measurement for energy representing the amount of heat required to raise the temperature of one pound of water one degree Fahrenheit.

**Current Yield:** The current yield is calculated by taking the current declared quarterly distribution annualized and dividing it by current stock price.

**Dekatherm:** A dekatherm is a measurement of energy content. One dekatherm is the approximate energy content of 1,000 cubic feet of natural gas (or 1 Mcf).

**Distributable Cash Flow (DCF):** DCF is the cash flow available to be paid to common unitholders after payments to the general partner.

**Distribution (Dividend) Discount Model (DDM):** DDM is an equity valuation tool used to estimate the present value of a stock based on the expected distributions (or dividends/future cash flow) received from the company.

**Distribution:** In a typical partnership agreement, the MLP is required to distribute all of its "available cash." MLPs typically distribute all available cash flow (i.e. cash flow from operations less maintenance CAPEX) to unitholders in the form of distributions (similar to dividends). However, management typically has some discretion in how much cash flow they choose to pay out.

**Distribution Coverage Ratio:** The coverage ratio indicates the cash available for distribution for every dollar to be distributed. The ratio is calculated by dividing available cash flow by distributions paid. Investors typically associate as the "cushion" a partnership has in paying its cash distribution. In this context, the higher the ratio, the greater the safety of the distribution.

**Dropdown:** A dropdown is the sale of an asset from the parent company (or sponsor company) to the underlying partnership. Dropdowns can also be defined as a transaction between two affiliated companies.

**Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA):** EBITDA is a non-GAAP measure used to provide an approximation of a company's profitability. This measure excludes the potential distortion that accounting and financing rules may have on a company's earnings; therefore, EBITDA is a useful tool when comparing companies that incur large amounts of depreciation expense because it excludes these non-cash items which could understate the company's true performance.

**Earnings Per Unit (EPU):** An MLPs' EPU is synonymous with a C corp.'s earnings per share (EPS). EPU is calculated by dividing net income allocated to the limited partners divided by the weighted average units outstanding at the end of the period.

**EBITDA Multiple:** An EBITDA multiple is the expected return an acquisition or organic growth project is estimated to generate. For example, a $100 million investment at an 8x EBITDA multiple, would be expected to generate approximately $12.5 million of EBITDA on an annual basis (or a 12.5% return).

**Excess Cash Flow:** Excess cash flow is the cash flow that remains after distributions have been paid to common and subordinated unitholders and general partner.

**Fractionation:** Fractionation is the process that involves the separation of the NGLs into discrete NGL purity products (i.e. ethane, propane, normal butane, iso-butane, and natural gasoline).

**Frac Spread (also known as "Processing Margin"):** The processing margin is the difference between the price of natural gas and a composite price for NGLs on a BTU-equivalent basis.

**General Partner (GP):** The GP (1) manages the day-to-day operations of the partnership, (2) generally has a 2% ownership stake in the partnership, and (3) is eligible to receive an incentive distribution (through the ownership of the MLPs' incentive distribution rights).

**Incentive Distribution Rights (IDRs):** IDRs allow the holder (typically the general partner) to receive an increasing percentage of quarterly distributions after the MQD and target distribution thresholds have been achieved. In most partnerships, IDRs can reach a tier wherein the GP is receiving 50% of every incremental dollar paid to the LP unitholders. This is known as the 50/50 or "high splits" tier.

**Limited Partner (LP):** The LP (1) provides capital, (2) has no role in the MLPs' operations or management, and (3) receives cash distributions.

**Liquid Petroleum Gases (LPGs):** LPGs are created (as a byproduct) during the refining of crude oil or from natural gas production. LPGs are typically a mixed form of propane and butane.

**Maintenance Capital Expenditures (CAPEX):** Maintenance CAPEX is the investment required to maintain the partnership's existing asset.

**Natural Gas Liquids (NGLs):** NGLs are extracted from the raw natural gas stream into a liquid mix (consisting of ethane, propane, butane, iso-butane, and natural gasoline). The NGLs are then typically transported via pipelines to fractionation facilities.

**Organic Growth Capital Expenditures (CAPEX):** Organic CAPEX is investments used to expand a company's operating capacity or operating income over the long-term.

**Processing:** Natural gas processing involves the separation of raw natural gas into "pipeline quality" gas and natural gas liquids.

**Tax Deferral Rate:** A percentage of the cash distribution to the unitholder that is tax deferred until the security is sold. The tax deferral rate on distributions ranges from 40-90%. The tax deferral rate is an approximation provided by the partnership and is only effective for a certain period of time.

## Energy Industry Abbreviations

**Bbls:** Barrels

**Bcf/d:** One billion cubic feet per day

**MBtu:** One thousand Btus.

**Mcf:** One thousand cubic feet of natural gas.

**MBbls:** One thousand barrels.

**MBbls/d:** One thousand barrels per day.

**MM:** In millions.

**MMBbls:** One million barrels.

**MMBbls/d:** One million barrels per day.

**MMBtu:** One million Btus.

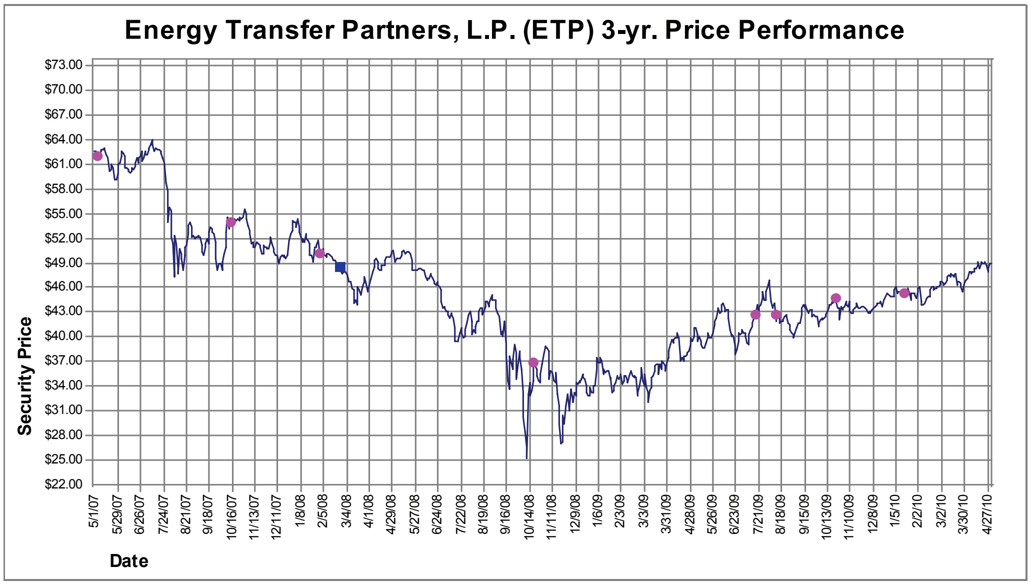
**MMBtu/d:** One million Btus per day.

**MMcf:** One million cubic feet of natural gas.

**MMcf/d:** One million cubic feet of natural gas per day.

**Tcf:** One trillion cubic feet of gas.

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 5/1/2007 | | Siegel | | | |
| | 5/1/2007 | NA | 1 | 59.00 | 63.00 | 62.46 |
| ● | 5/4/2007 | NA | 1 | 64.00 | 69.00 | 62.00 |
| ● | 10/15/2007 | 53.81 | 1 | 63.00 | 68.00 | 53.94 |
| ● | 1/30/2008 | 51.64 | 1 | 55.00 | 59.00 | 50.14 |
| ■ | 2/25/2008 | | Blum | | | |
| ● | 10/20/2008 | 34.64 | 1 | 48.00 | 51.00 | 36.80 |
| ● | 7/16/2009 | 42.21 | 1 | 49.00 | 52.00 | 42.64 |
| ● | 8/12/2009 | 41.82 | 1 | 47.00 | 50.00 | 42.77 |
| ● | 10/22/2009 | 44.24 | 1 | 48.00 | 52.00 | 44.71 |
| ● | 1/15/2010 | 45.09 | 1 | 51.00 | 55.00 | 45.34 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
▼ Rating Downgrade
▲ Rating Upgrade
● Valuation Range Change
◆ Initiation, Resumption, Drop or Suspend
■ Analyst Change
❐ Split Adjustment

**Rating Code Key**
1 Outperform/Buy
2 Market Perform/Hold
3 Underperform/Sell
SR Suspended
NR Not Rated
NE No Estimate

## Additional Information Available Upon Request

I certify that:
1) All views expressed in this research report accurately reflect my personal views about any and all of the subject securities or issuers discussed; and
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As of: May 7, 2010

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May 7, 2010

WELLS FARGO SECURITIES

# *Equity Research*

## ExlService Holdings, Inc.

**EXLS: Surprise 2011 Guidance Better Than Expected; Raising Ests**
**Q1 Solid, 2010 Guided Higher, 20+% Organic Growth Guided In 2011**

**Market Perform / V**

Sector: Offshore Outsourcing
Market Weight

- **Summary: Strong Q1 Results and Tuck-in Acquisition Drive 2010 Guidance Higher, 2011 Organic Growth Above Expectations.** ExlService (EXLS) reported Q1 revenue of $54MM, up ~29% yr/yr organic, which was better than expected. EPS of $0.19 was well above consensus of $0.13 and our $0.11 estimate. 2010 revenue guidance raised to account for small acquisition and improved visibility, with adjusted operating margin now expected near top of prior 12-14% range. EXLS unexpectedly set 2011 growth target of ~30% including organic expectations of 20% or better. We are raising our 2010 EPS estimate to $0.69 from $0.56 and 2011 to $0.81 from $0.68. Our Valuation Range now $18-19 from $17-18. We reiterate our Market Perform rating with a positive bias.
- **Solid Q1 Results.** Revenue of $54MM was up 33% yr/yr and flat q/q (ex Q4 Aviva payment), and includes one month of recent AmEx captive acquisition. Our and the Street's estimate were $53MM/$52.1MM. Outsourcing revenue was up 25% yr/yr, while more discretionary Transformation services revenue was up 70% yr/yr. Gross margin and continued cost containment drove operating margin to 11.9% and EPS to $0.19, above our/Street estimates of $0.11/$0.13. Seat utilization of 1.27x was flat q/q.
- **2010 Guidance Revision Better Than Expected.** Revenue guided to $235-240MM from $225-230MM and assumes ~$6-7MM from recently acquired PDMA, and greater visibility on demand in H2. Our/Street estimate was $228MM. Adjusted operating margin guidance of 12-14% is reaffirmed and biased toward the top end of range. Guidance for FX hedge gains raised given rupee appreciation.
- **Positive 2011 Guidance Issued Unexpectedly.** EXLS guided 2011 organic growth to 20% plus based largely on current book of business, and expects to add an additional ten points of growth through smaller acquisitions. Our prior estimate was 16% organic; Street 15%. The company is optimistic it can improve upon current adjusted EBITDA (adj op margin less depreciation) levels.

### *Earnings Estimates Revised Up*

| | 2009A | 2010E | | 2011E | |
|---|---|---|---|---|---|
| **EPS** | | **Curr.** | **Prior** | **Curr.** | **Prior** |
| **Q1** (Mar.) | $0.10 | **$0.19 A** | **0.11** | **$0.20** | **0.12** |
| **Q2** (June) | 0.04 | **0.15** | **0.14** | **0.17** | **0.16** |
| **Q3** (Sep.) | 0.14 | **0.17** | **0.14** | **0.20** | **0.19** |
| **Q4** (Dec.) | 0.25 | **0.18** | **0.17** | **0.24** | **0.21** |
| **FY** | $0.53 | **$0.69** | **0.56** | **$0.81** | **0.68** |
| **CY** | $0.53 | $0.69 | | $0.81 | |
| **FY P/E** | 30.4x | 23.4x | | 19.9x | |
| **Rev.(MM)** | $191 | $238 | | $284 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

| | |
|---|---|
| Ticker | EXLS |
| Price (05/07/2010) | $16.11 |
| 52-Week Range: | $8-20 |
| Shares Outstanding: (MM) | 29.1 |
| Market Cap.: (MM) | $468.8 |
| S&P 500: | 1,117.58 |
| Avg. Daily Vol.: | 46,118 |
| Dividend/Yield: | $0.00/0.0% |
| LT Debt: (MM) | $0.0 |
| LT Debt/Total Cap.: | NM |
| ROE: | 9.0% |
| 3-5 Yr. Est. Growth Rate: | 20.0% |
| CY 2010 Est. P/E-to-Growth: | 1.2x |
| Last Reporting Date: | 05/05/2010 After Close |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

**Valuation Range: $18.00 to $19.00** **from $17.00 to $18.00**
We expect the shares to trade in a range of $18-19, which is 10-11x our 2010 EV/adjusted operating income estimate. Risks to our valuation range include potential economic/credit driven declines in activity levels, notable client concentration, slow ramp of new facilities, uneven pace of FX gains/losses, integration risk of potential acquisitions, and potential share overhang given 37% ownership by a pre-IPO investor.

**Investment Thesis:**
We expect EXLS to be one on a very short list of pure-play service providers to benefit from the expected growth of offshore BPO over the next several years. Insurance clients represent half of revenue and provide a strong base to expand into other verticals, which is already occurring. Near-term results are being impacted by general economic/credit activity and client specific issues.


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**Please see page 8 for rating definitions, important disclosures and required analyst certifications**






## Company Description:

ExlService Holdings, Inc. (EXLS) is one of the leading offshore providers of business process outsourcing (BPO) and analytics services with a primary focus on financial services, particularly insurance, with revenue split between the United States (two-thirds) and the United Kingdom.

**Revised Model Assumptions**

($ in millions, except EPS)

| | OLD 2010E | NEW 2010E | OLD 2011E | NEW 2011E |
|---|---|---|---|---|
| **Revenue** | **$228.0** | **$238.0** | **$265.0** | **284.0** |
| % increase/ (decrease) | 19% | 25% | 16% | 19% |
| Operating income | 20.0 | 22.6 | 26.6 | 30.0 |
| Adjusted operating income | 30.7 | 33.5 | 38.4 | 42.0 |
| **EPS – GAAP** | **$0.56** | **$0.69** | **$0.68** | **$0.81** |
| Avg. shares out (diluted) | 30.2 | 30.3 | 30.8 | 31.0 |
| Gross margin | 39.1% | 39.8% | 39.3% | 39.8% |
| Adjusted operating margin | 13.5 | 14.1 | 14.5 | 14.8 |
| Operating margin | 8.8 | 9.5 | 10.0 | 10.5 |
| Tax rate | 25.0 | 25.0 | 23.0 | 23.0 |

Source: Company data and Wells Fargo Securities, LLC estimates

### Model Revision Commentary

We are raising our 2010 revenue and EPS estimates to account for this quarter's upside relative to our expectation, the PDMA acquisition, and a more positive assumption on revenue growth from recently won clients. EPS now $0.69 from $0.56 on higher revenue, greater assumed gross and operating margins and higher assumed FX hedge gains. Our 2011 EPS estimate now $0.81 from $0.68 on higher assumed revenue and greater operating leverage.

### Q1 2010 Takeaways

### Q1 Revenue Slightly Above Expectation

- EXLS reported Q1 revenue of $54.5 million, up 33% yr/yr and ~0.3% q/q (excluding Q4 Aviva payment of $5.1 million). Our estimate was $53.0 million; Street estimate was $52.1 million. We estimate organic growth (excludes AmEx captive) was 29% yr/yr and down 3% q/q.
- Outsourcing segment revenue of $41.6 million (76% of total revenue) was up 25% yr/yr and down ~1% q/q (excluding Q4 Aviva payment). EXLS recorded $800K in Aviva revenue on continued wind down of the account.
- Transformation segment revenue of $12.9 million was up 70% yr/yr and up 4.3% q/q. Approximately $1 million of Q4 budget flush was recognized in the quarter. Annuity-based Transformation revenue, defined as services contracted for 12 months or more, was stable at one third of the total.

**Q1 Revenue - Segment Breakdown**

($ in millions)

| | Q1 2010 | % Total | Yr/Yr Change | Q/Q Change |
|---|---|---|---|---|
| Insurance | 29.2 | 54% | 29% | -0.7% |
| Utilities | 12.8 | 23 | 37 | -2.4 |
| Banking, Financial Services | 5.4 | 10 | 26 | -9.9 |
| Transportation | 3.9 | 7 | 34 | -17.2 |
| Other | 3.3 | 6 | 76 | 174.4 |
| Total | 54.5 | | 33 | 0.3 |

Note: Sequential growth for Insurance and Total revenue exclude a $5.1 million, one-time payment for Aviva transition in Q4 2009.
Source: Company data and Wells Fargo Securities, LLC estimates

**Q1 EPS – Well Ahead of Estimates**

- Q1 EPS was $0.19, up from $0.10 in the year-ago period (continuing operations).
- Our estimate was $0.11; Street estimate was $0.13.
- Gross margin of 42.2% versus 40.6% a year-ago.
  - Outsourcing services segment gross margin of 43.3% versus 45.3% a year-ago and 46.3% q/q (ex Aviva payment).
  - Transformation services segment gross margin of 38.7% 19.7% a year-ago and 36.2% q/q, driven by higher utilization.
- GAAP operating margin of 11.9%. Our estimate was 7.1%.
- Adjusted operating margin of 15.6% compared to our estimate of 12.0%.
- FX gain of $0.6 compares to our estimated gain of $0.5 million.
- Tax rate of 25.0% compares to our estimated tax rate of 25.0%.

**Financial Highlights for the March 2010 Quarter**

(in $ millions, except EPS)

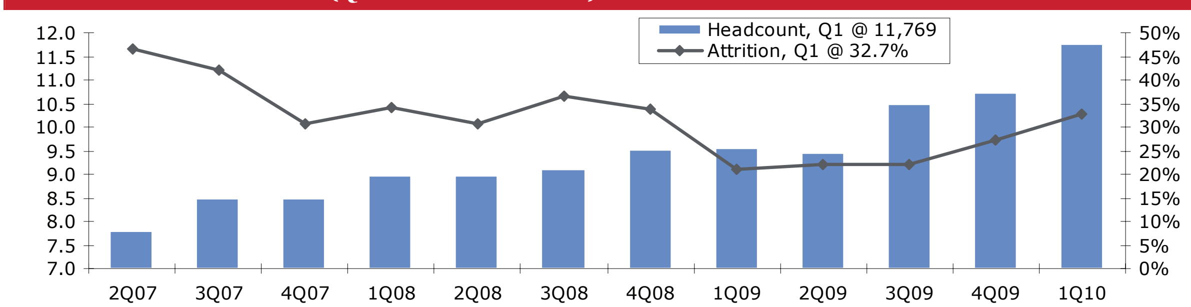
| | Q1 2009 | Q1 2010E | Q1 2010A |
|---|---|---|---|
| **Revenue** | **$41.0** | **$53.0** | **$54.5** |
| Yr/Yr Change | (8%) | 29% | 33% |
| Gross profit | 16.6 | 20.4 | 23.0 |
| Operating income | 4.3 | 3.7 | 6.5 |
| Pretax income | 3.3 | 4.4 | 7.5 |
| Net income (cont. ops) | 2.9 | 3.3 | 5.6 |
| | | | |
| EPS – GAAP | $0.10 | $0.11 | $0.19 |
| **EPS – Pro forma (cont. ops)** | **$0.10** | **$0.11** | **$0.19** |
| Average shares | 29.1 | 30.0 | 30.2 |
| | | | |
| Gross margin | 40.6% | 38.5% | 42.2% |
| Adjusted operating margin | 14.2 | 12.0 | 15.6 |
| Operating margin | 10.4 | 7.1 | 11.9 |
| Tax rate | 8.0 | 25.0 | 25.0 |

Source: Company data and Wells Fargo Securities, LLC estimates.

**People Metrics – Headcount Higher on AmEx, Ramp of New Business**

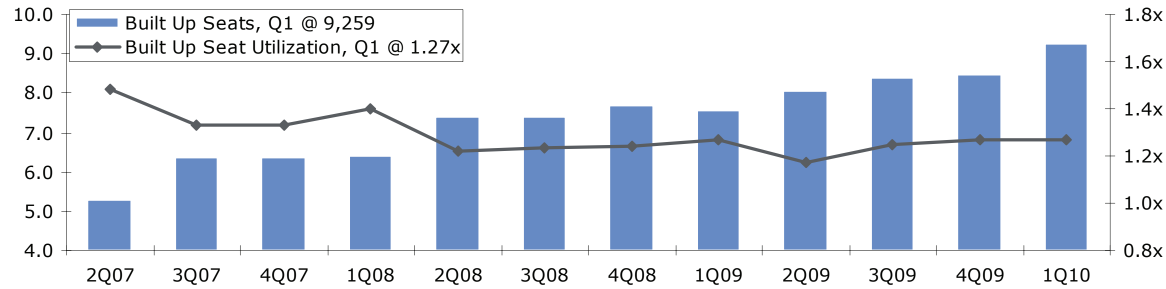
- Headcount was 11,769 at quarter end, up 1,033 net from 10,736 at the end of Q4.
- Sales headcount of 55 is up from ~48 q/q.
- Total workstations were 9,259, up 776 from Q4. Workstation utilization (quarter-end basis) was flat at 1.27x from Q4 and Q1 2009. Q1 exit rate was 1.19x, reflecting continued ramp of new clients.
- Build out of new SEZ facilities in Noida and Jaipur are to be phased: Noida capacity utilization is expected to be ~50% by year-end; Jaipur is expected to be at ~100%.
- Q1 attrition of 32.7% compares to 27%, 22%, 22%, and 21% in the sequentially prior periods.

**Headcount and Attrition (Quarter-Annualized)**




Source: Company data.

## Built-up Seats & Utilization




Source: Company data.

**2010 Guidance Revised Higher; 2011 Growth Expectations of 20% "Plus" Organic**

- 2010 revenue guided to $235-240 million, up from prior guidance of $225-230 million, which implies yr/yr growth of 23-26%. Positive guidance adjustment of $10 million reflects contribution from recently acquired PDMA of ~$6-7 million, ramp of recent wins and enhanced visibility toward demand from existing clients in outsourcing and transformation. Contribution from AmEx is expected at $20 million annualized in 2010 (unchanged), so ~$5 million per quarter in Q2 through Q4.
- Unexpectedly, EXLS provided 2011 growth expectations of 20% "plus" organic based on current book of business and assumed capture of pending outsourcing award with a greenfield insurance client. The company believes M&A can add an additional ten points of growth in 2011, for a total of ~30%. Guidance assumes adjusted operating margin is sustainable.
- EXLS closed three new outsourcing contracts (one which we estimate is a renewal with EXLS' largest insurance client) and eight new transformation services clients in Q1.
- Amortization of acquired intangibles related to AmEx is guided to ~$800K in 2010 and 2011.
- Adjusted operating margin of 12-14% range is reaffirmed, although the bias is now toward the top end, assuming current exchange rates (Rs. 44.5/$ and ~$1.51/GBP). Assuming Q4 INR rate, EXLS indicated AOM guidance would have been raised 110bps.
- FX gains are estimated at ~$4 million for the year, up from prior guidance of ~$2 million.

## Summary of Guidance Revisions

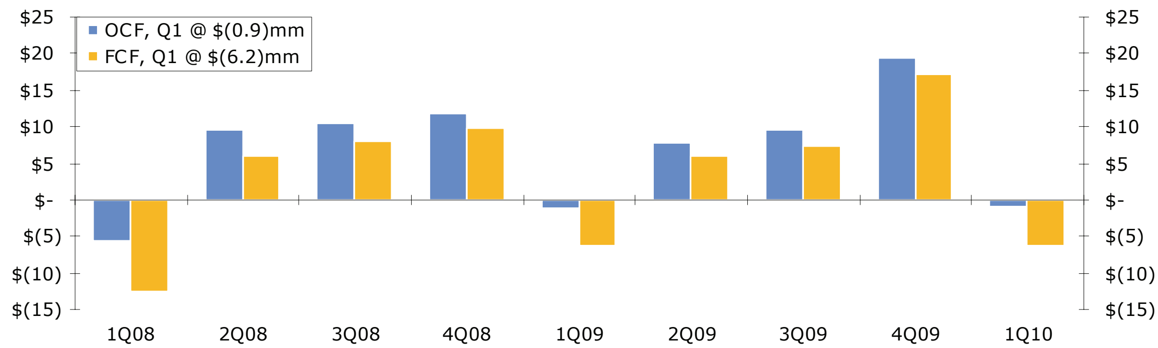
| ($ in millions, except EPS) | Our Prior Estimate | Prior Street Estimate | Prior Guidance | New Guidance |
|---|---|---|---|---|
| **2010** | | | | |
| Revenue | $228.0 | $227.9 | $225-230 | $235-240 |
| Adjusted Operating Margin | 13.5% | NA | 12-14% | 12-14% |
| EPS | $0.56 | $0.61 | none provided | none provided |
| **Q2 2010** | | | | |
| Revenue | $56.0 | $55.7 | none provided | none provided |
| EPS | $0.14 | $0.14 | none provided | none provided |

Source: Company data, Thomson ONE, and Wells Fargo Securities, LLC estimates.

**Cash Flow Seasonally In-line**

- Q1 DSO was 58 days compared to 58, 59, 68, 70 sequentially.
- Q1 cash from operations was $(0.9) million.
- CapEx was $5.4 million. The expectation for CapEx in 2010 is $20-25 million as the new Jaipur and Noida facilities come on stream in Q2 and Q3.
- Therefore, Q1 free cash flow was $(6.2) million.

**Operating & Free Cash Flow (in $ millions)**




Source: Company data.

**Balance Sheet – Considerable Cash Post AmEx Transaction**

- Cash balance was $101.5 million on March 31, versus $136.2 million on December 31.
- There is no debt.
- EXLS completed the purchase of the AmEx captive for $29.1 million.
- EXLS expects to remain active in M&A going forward, and is focused on acquiring assets which enable a U.S.-based onshore delivery platform and/or strengthen the company's domain expertise within its key verticals of travel/logistics, banking/financial services/insurance, and utilities.

**Tuck-in Acquisition Announced.** EXLS has acquired PDMA, a U.S.-based developer of policy administration software for the life and health insurance sectors, effective May 1. The acquisition is intended to deepen EXLS' domain expertise in annuity and non-P&C insurance BPO markets and improve exposure to outcome-based pricing. EXLS is paying $14.1 million (1.4x sales), and expects the transaction to be accretive to 2010 GAAP EPS.

**ExlService Holdings, Inc.**
**Annual Earnings Model, 2003-11E**

| ($ in thousands, except per share) | 2003 | 2004 | 2005 | Restated 2006 | Restated 2007 | Restated 2008 | 2009 | 2010E | 2011E |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | Guidance: | $235-240mm | |
| **Total Revenue** | **$27,771** | **$60,467** | **$73,954** | **$98,679** | **$152,033** | **$181,714** | **$190,995** | **$237,989** | **$284,000** |
| Cost of revenue (excl. D&A) | 18,443 | 38,716 | 47,598 | 62,619 | 100,112 | 112,436 | 109,389 | 143,248 | 171,068 |
| **Gross Profit** | **9,328** | **21,751** | **26,356** | **36,061** | **51,921** | **69,277** | **81,606** | **94,741** | **112,933** |
| G&A | 7,891 | 11,085 | 13,200 | 18,698 | 28,724 | 31,113 | 31,850 | 39,421 | 45,179 |
| Selling & marketing | 1,104 | 1,456 | 1,685 | 4,739 | 9,171 | 11,344 | 13,950 | 18,010 | 21,222 |
| Other | - | - | - | - | - | - | - | - | - |
| **EBITDA** | **333** | **9,209** | **11,471** | **12,623** | **14,026** | **26,821** | **35,806** | **37,311** | **46,532** |
| Depreciation & amortization | 421 | 3,909 | 5,889 | 7,099 | 9,212 | 11,156 | 11,405 | 14,673 | 16,850 |
| **Operating Income** | **(88)** | **5,300** | **5,582** | **5,525** | **4,814** | **15,665** | **24,401** | **22,638** | **29,682** |
| F/X Gain/(Loss) | 445 | 774 | 942 | (478) | 7,584 | (9,276) | (5,929) | 3,906 | 1,500 |
| Interest and other income | 215 | 259 | 694 | 1,889 | 4,258 | 3,408 | 1,023 | 1,243 | 1,350 |
| Interest expense (incl. pref.) | (559) | (931) | (806) | (579) | (55) | - | - | - | - |
| Nonrecurring | - | - | - | - | - | - | - | - | - |
| **Pretax Income** | **12** | **5,402** | **6,413** | **6,356** | **16,601** | **9,797** | **19,495** | **27,787** | **32,532** |
| Provision (benefit) for income taxes | 770 | 22 | (647) | (361) | (974) | (1,340) | 3,703 | 6,949 | 7,482 |
| **Income from continuing ops** | **(757)** | **5,380** | **7,060** | **6,717** | **17,575** | **11,137** | **15,792** | **20,838** | **25,049** |
| Income/(loss) from disco | | | | 7,341 | 9,469 | 3,271 | (139) | - | - |
| Dividends to preferred | (258) | - | (249) | (617) | - | - | - | - | - |
| **Net Income to Common** | **(1,015)** | **5,380** | **6,810** | **13,440** | **27,044** | **14,408** | **15,653** | **20,838** | **25,049** |
| EPS--GAAP | **($0.05)** | **$0.26** | **$0.32** | **$0.58** | **$0.93** | **$0.49** | **$0.53** | **$0.69** | **$0.81** |
| EPS - continuing operations | (0.05) | 0.26 | 0.32 | 0.29 | 0.60 | 0.38 | 0.54 | 0.69 | 0.81 |
| Avg. shares outstanding-diluted | 19,569 | 21,017 | 21,591 | 23,033 | 29,191 | 29,212 | 29,418 | 30,308 | 30,958 |
| **Yr/Yr % change** | | | | | | | | | |
| **Revenue** | **NA** | **118%** | **22%** | **33%** | **54%** | **20%** | **5%** | **25%** | **19%** |
| Operating income | NA | NM | 5 | (1) | (13) | 225 | 56 | (7) | 31 |
| Pretax income | NA | NM | 19 | (1) | 161 | (41) | 99 | 43 | 17 |
| Net income to common | NA | NM | 27 | 97 | 101 | (47) | 9 | 33 | 20 |
| **EPS** | **NA** | **NM** | **23** | **85** | **59** | **(47)** | **8** | **29** | **18** |
| Avg. no. of shares | NA | 7 | 3 | 7 | 27 | 0 | 1 | 3 | 2 |
| | | | | | | | Adjusted OM guidance: | 12-14% | |
| Gross margin | 33.6% | 36.0% | 35.6% | 36.5% | 34.2% | 38.1% | 42.7% | 39.8% | 39.8% |
| G&A/revenue | 28.4 | 18.3 | 17.8 | 18.9 | 18.9 | 17.1 | 16.7 | 16.6 | 15.9 |
| Selling & mktg/revenue | 4.0 | 2.4 | 2.3 | 4.8 | 6.0 | 6.2 | 7.3 | 7.6 | 7.5 |
| EBITDA Margin | 1.2 | 15.2 | 15.5 | 12.8 | 9.2 | 14.8 | 18.7 | 15.7 | 16.4 |
| D&A/revenue | 1.5 | 6.5 | 8.0 | 7.2 | 6.1 | 6.1 | 6.0 | 6.2 | 5.9 |
| Operating Margin | -0.3 | 8.8 | 7.5 | 5.6 | 3.2 | 8.6 | 12.8 | 9.5 | 10.5 |
| **Adjusted Operating Margin** | **-0.3** | **8.8** | **7.7** | **8.8** | **7.1** | **11.8** | **16.6** | **14.1** | **14.8** |
| Pretax margin | 0.0 | 8.9 | 8.7 | 6.4 | 10.9 | 5.4 | 10.2 | 11.7 | 11.5 |
| Net margin | -3.7 | 8.9 | 9.2 | 13.6 | 17.8 | 7.9 | 8.2 | 8.8 | 8.8 |
| Tax rate | 6285.2 | 0.4 | -10.1 | -5.7 | -5.9 | -13.7 | 19.0 | 25.0 | 23.0 |
| | | | | | | | Tax rate guidance: | mid-20s | |

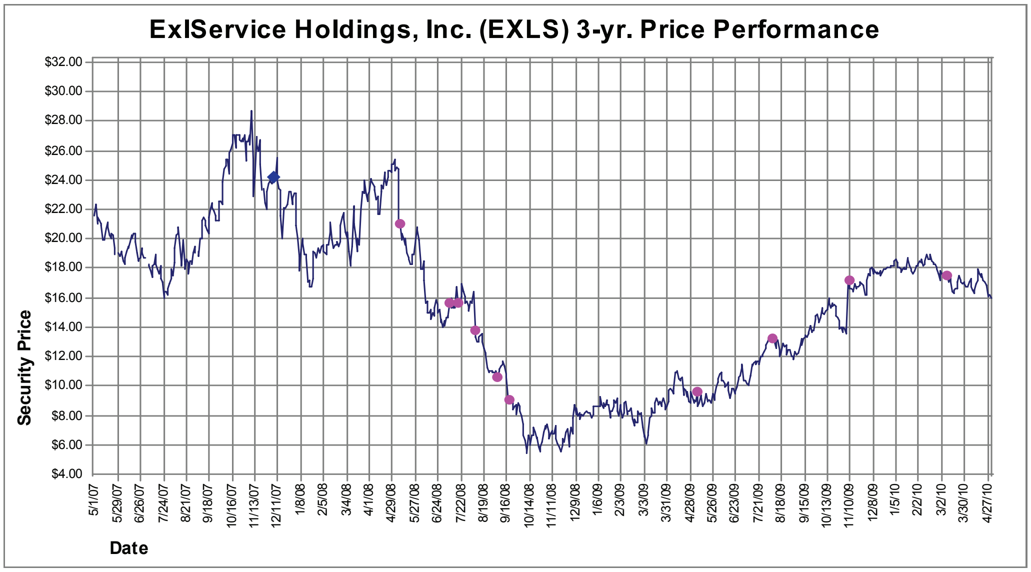
Note: 2006-2008 results reflect Aviva BOT as a discontinued operation; 2004-2005 are not restated
Source: Company data and Wells Fargo Securities, LLC estimates

**ExlService Holdings, Inc.**
**Quarterly Earnings Model, FY 2009-11E**
($ in thousands, except per share)

| | Q1 2009 | Q2 2009 | Q3 2009 | Q4 2009 | Q1 2010 | Q2 2010E | Q3 2010E | Q4 2010E | Q1 2011E | Q2 2011E | Q3 2011E | Q4 2011E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | $46.4-48.4mm | | | | | | | | |
| **Total Revenue** | **$40,986** | **$42,385** | **$48,186** | **$59,438** | **$54,489** | **$59,500** | **$61,000** | **$63,000** | **$65,000** | **$69,000** | **$72,000** | **$78,000** |
| Cost of revenue (excl. D&A) | 24,356 | 25,827 | 28,803 | 30,403 | 31,485 | 36,794 | 37,064 | 37,905 | 38,523 | 42,705 | 43,545 | 46,295 |
| **Gross Profit** | **16,630** | **16,558** | **19,383** | **29,035** | **23,004** | **22,706** | **23,936** | **25,095** | **26,478** | **26,295** | **28,455** | **31,705** |
| G&A | 6,733 | 7,634 | 7,770 | 9,713 | 9,305 | 9,818 | 10,004 | 10,294 | 10,595 | 11,040 | 11,376 | 12,168 |
| Selling & marketing | 3,184 | 3,340 | 3,516 | 3,910 | 4,150 | 4,522 | 4,575 | 4,763 | 4,875 | 5,175 | 5,400 | 5,772 |
| Other | - | - | - | - | - | - | - | - | - | - | - | - |
| **EBITDA** | **6,713** | **5,584** | **8,097** | **15,412** | **9,549** | **8,367** | **9,357** | **10,038** | **11,008** | **10,080** | **11,679** | **13,765** |
| Depreciation & amortization | 2,430 | 2,789 | 2,918 | 3,268 | 3,073 | 3,750 | 3,900 | 3,950 | 4,025 | 4,150 | 4,275 | 4,400 |
| **Operating Income** | **4,283** | **2,795** | **5,179** | **12,144** | **6,476** | **4,617** | **5,457** | **6,088** | **6,983** | **5,930** | **7,404** | **9,365** |
| F/X Gain/(Loss) | (1,309) | (1,710) | (1,995) | (915) | 606 | 1,100 | 1,100 | 1,100 | 750 | 500 | 250 | - |
| Interest and other income | 311 | 276 | 269 | 167 | 418 | 250 | 275 | 300 | 300 | 325 | 350 | 375 |
| Interest expense | - | - | - | - | - | - | - | - | - | - | - | - |
| Nonrecurring | - | - | - | - | - | - | - | - | - | - | - | - |
| **Pretax Income** | **3,285** | **1,361** | **3,453** | **11,396** | **7,500** | **5,967** | **6,832** | **7,488** | **8,033** | **6,755** | **8,004** | **9,740** |
| Provision (benefit) for income taxes | 263 | 109 | (541) | 3,872 | 1,877 | 1,492 | 1,708 | 1,872 | 1,847 | 1,554 | 1,841 | 2,240 |
| **Income from continuing ops** | **3,022** | **1,252** | **3,994** | **7,524** | **5,623** | **4,475** | **5,124** | **5,616** | **6,185** | **5,201** | **6,163** | **7,500** |
| Income/(loss) from disco | (139) | - | - | - | - | - | - | - | - | - | - | - |
| Dividends to preferred | - | - | - | - | - | - | - | - | - | - | - | - |
| **Net Income to Common** | **2,883** | **1,252** | **3,994** | **7,524** | **5,623** | **4,475** | **5,124** | **5,616** | **6,185** | **5,201** | **6,163** | **7,500** |
| | | | FY: | $0.53 | | | FY: | $0.69 | | | FY: | $0.81 |
| EPS--GAAP | $0.10 | **$0.04** | **$0.14** | **$0.25** | **$0.19** | **$0.15** | **$0.17** | **$0.18** | **$0.20** | **$0.17** | **$0.20** | **$0.24** |
| EPS - continuing operations | **0.10** | 0.04 | 0.14 | 0.25 | 0.19 | 0.15 | 0.17 | 0.18 | 0.20 | 0.17 | 0.20 | 0.24 |
| Avg. shares outstanding-diluted | 29,080 | 29,160 | 29,368 | 29,933 | 30,158 | 30,258 | 30,358 | 30,458 | 30,658 | 30,858 | 31,058 | 31,258 |
| **Yr/Yr % change** | | | | | | | | | | | | |
| **Revenue - Yr/yr** | **-8%** | **-10%** | **3%** | **36%** | **33%** | **40%** | **27%** | **6%** | **19%** | **16%** | **18%** | **24%** |
| **Revenue - sequential** | (6) | 3 | 14 | 23 | (8) | 9 | 3 | 3 | 3 | 6 | 4 | 8 |
| Operating income | 69 | 14 | (2) | 125 | 51 | 65 | 5 | (50) | 8 | 28 | 36 | 54 |
| Pretax income | (30) | (39) | (1,705) | 0 | 128 | 338 | 98 | (34) | 7 | 13 | 17 | 30 |
| Net income to common | (58) | (76) | (471) | 120 | 95 | 257 | 28 | (25) | 10 | 16 | 20 | 34 |
| **EPS** | **(35)** | **(51)** | **960** | **114** | **79** | **244** | **24** | **(27)** | **8** | **14** | **18** | **30** |
| Avg. no. of shares | (1) | (1) | 1 | 3 | 4 | 4 | 3 | 2 | 2 | 2 | 2 | 3 |
| Gross margin | 40.6% | 39.1% | 40.2% | 48.8% | 42.2% | 38.2% | 39.2% | 39.8% | 40.7% | 38.1% | 39.5% | 40.6% |
| G&A/revenue | 16.4 | 18.0 | 16.1 | 16.3 | 17.1 | 16.5 | 16.4 | 16.3 | 16.3 | 16.0 | 15.8 | 15.6 |
| Selling & mktg/revenue | 7.8 | 7.9 | 7.3 | 6.6 | 7.6 | 7.6 | 7.5 | 7.6 | 7.5 | 7.5 | 7.5 | 7.4 |
| EBITDA Margin | 16.4 | 13.2 | 16.8 | 25.9 | 17.5 | 14.1 | 15.3 | 15.9 | 16.9 | 14.6 | 16.2 | 17.6 |
| D&A/revenue | 5.9 | 6.6 | 6.1 | 5.5 | 5.6 | 6.3 | 6.4 | 6.3 | 6.2 | 6.0 | 5.9 | 5.6 |
| Operating Margin | 10.4 | 6.6 | 10.7 | 20.4 | 11.9 | 7.8 | 8.9 | 9.7 | 10.7 | 8.6 | 10.3 | 12.0 |
| **Adjusted Operating Margin** | **14.2** | **11.3** | **14.8** | **23.4** | **15.6** | **12.6** | **13.9** | **14.4** | **15.5** | **13.1** | **14.6** | **15.9** |
| Pretax margin | 8.0 | 3.2 | 7.2 | 19.2 | 13.8 | 10.0 | 11.2 | 11.9 | 12.4 | 9.8 | 11.1 | 12.5 |
| Net margin | 7.0 | 3.0 | 8.3 | 12.7 | 10.3 | 7.5 | 8.4 | 8.9 | 9.5 | 7.5 | 8.6 | 9.6 |
| Tax rate | 8.0 | 8.0 | -15.7 | 34.0 | 25.0 | 25.0 | 25.0 | 25.0 | 23.0 | 23.0 | 23.0 | 23.0 |

Note: Q4 2009 includes a $5.1 million payment from Aviva that impacts revenue and EPS (we estimate by $0.11).
Source: Company data and Wells Fargo Securities, LLC estimates

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 12/6/2007 | | Caso | | | |
| | 12/6/2007 | 24.19 | 2 | 23.00 | 27.00 | 24.19 |
| | 5/8/2008 | 20.76 | 2 | 20.00 | 23.00 | 20.99 |
| | 7/8/2008 | 15.58 | 2 | 16.00 | 28.00 | 15.58 |
| | 7/18/2008 | 15.40 | 2 | 16.00 | 18.00 | 15.60 |
| | 8/7/2008 | 13.23 | 2 | 13.00 | 15.00 | 13.74 |
| | 9/4/2008 | 10.53 | 2 | 12.00 | 14.00 | 10.53 |
| | 9/19/2008 | 9.26 | 2 | 8.00 | 9.00 | 9.10 |
| | 5/6/2009 | 9.57 | 2 | 9.00 | 10.00 | 9.57 |
| | 8/6/2009 | 13.21 | 2 | 12.50 | 13.50 | 13.21 |
| | 11/9/2009 | 16.92 | 2 | 16.00 | 17.50 | 17.20 |
| | 3/9/2010 | 17.48 | 2 | 17.00 | 18.00 | 17.48 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- □ Split Adjustment

**Rating Code Key**

| | | | |
|---|---|---|---|
| 1 | Outperform/Buy | SR | Suspended |
| 2 | Market Perform/Hold | NR | Not Rated |
| 3 | Underperform/Sell | NE | No Estimate |

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**3=Underperform:** The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

## SECTOR RATING

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As of: May 7, 2010

| | |
|---|---|
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May 7, 2010

# Equity Research

## Exterran Partners, L.P.

**EXLP: Q1 In Line With Full-Quarter Benefit From Dropdown**

**Outperform / V**

Sector: Small Cap Pipeline MLPs
Overweight

- **Key Takeaways**. Q1 adjusted EBITDA was essentially in line with our forecast, but DCF was above expectations due to timing of maintenance capex. We are maintaining our 2010 and 2011 DCF per unit estimates of $2.30 and $2.80, respectively. Despite headwinds from a low natural gas price environment on domestic demand for contract compression, EXLP's distribution remains secure, in our view. Q1 coverage was 1.2x and the GP remains supportive via potential dropdowns and cost cap adjustments, which help strengthen the partnership's cash flow. With an attractive yield of 8.2% (versus 8.1% for small-cap pipeline MLPs), risk/reward for EXLP remains compelling, in our view.
- **Operating Results Essentially In Line.** Q1 adjusted EBITDA was $22.4MM versus our estimate of $23.4MM. EPU of $0.05 was slightly below our forecast of $0.08 primarily due to higher-than-anticipated DD&A expense. Q1 results reflect a full-quarter benefit from the $143MM acquisition of 270,000 horsepower (hp) from the partnership's GP sponsor (EXH), completed in November 2009. The benefit from (1) higher-than-expected hp utilization (81% versus our estimate of 78% and 79% in Q4 2009) and (2) slightly lower-than-anticipated SG&A expense of approximately $1MM was more than offset by the impact of a lower adjusted gross margin (i.e. 56% versus our forecast of 58%). Excluding the operating cost cap of $2.8MM, gross margin was 51%.
- **DCF Higher On Capex Timing But Distribution In Line.** Q1 DCF per unit of $0.58 was ahead of our forecast of $0.48 primarily due to lower-than-expected maintenance capex (i.e. $2MM versus our estimate $5MM). As anticipated, EXLP maintained its quarterly distribution of $0.4625 (or $1.85 annualized). Q1 distribution coverage was solid at 1.2x (or excess cash flow of $3MM).

### *Earnings Reported - Full Analysis*

| | 2009A | 2010E | | 2011E | |
|---|---|---|---|---|---|
| **DCF/unit** | | **Curr.** | **Prior** | **Curr.** | **Prior** |
| **Q1** (Mar.) | $0.67 | **$0.58 A** | **0.48** | $0.70 | NC |
| **Q2** (June) | 0.64 | **0.41** | **0.52** | **0.69** | **0.70** |
| **Q3** (Sep.) | 0.53 | **0.58** | **0.59** | 0.69 | NC |
| **Q4** (Dec.) | 0.58 | **0.70** | **0.68** | **0.72** | **0.71** |
| **FY** | $2.42 | $2.30 | NC | $2.80 | NC |
| **CY** | $2.42 | $2.30 | | $2.80 | |
| **FY P/DCF** | 9.3x | 9.8x | | 8.0x | |
| **Rev.(MM)** | $182 | $268 | | $415 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

| | |
|---|---|
| Ticker | EXLP |
| Price (05/06/2010) | $22.44 |
| 52-Week Range: | $12-27 |
| Shares Outstanding: (MM) | 19.1 |
| Market Cap.: (MM) | $428.6 |
| S&P 500: | 1,128.15 |
| Avg. Daily Vol.: | 60,459 |
| Dividend/Yield: | $1.85/8.2% |
| LT Debt: (MM) | $430.5 |
| LT Debt/Total Cap.: | 63.0% |
| ROE: | NE |
| 3-5 Yr. Est. Growth Rate: | 5.0% |
| CY 2010 Est. P/DCF/unit-to-Growth: | 2.0x |
| Last Reporting Date: | 05/06/2010 Before Open |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

**Valuation Range: $25.00 to $27.00**
Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 9.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 11x our 2010 estimate. Risks to the units trading below our valuation range include dependence on acquisitions to fuel growth, customer concentration, and rising interest rates.

**Investment Thesis:**
EXLP is well positioned to grow its distribution at a five-year CAGR of about 5% predicated on potential drop-downs from its GP's domestic fleet. Of note, EXLP acquired $143MM of assets in Q4'09. Risk/reward remains attractive based on the partnership's above-average yield, which is underpinned by fee-based cash flows. Approximately 80% of EXLP's distribution is tax deferred.

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**Please see page 7 for rating definitions, important disclosures and required analyst certifications**

## Company Description:

Exterran Partners, L.P. is a Houston-based master limited partnership (MLP) that provides natural gas contract compression services to customers throughout the United States. These services include designing, sourcing, owning, installing, operating, servicing, repairing, and maintaining equipment to provide compression to customers. The general partner (GP) of the partnership is owned and managed by Exterran Holdings, Inc. (EXH).

## Key Takeaways

Q1 adjusted EBITDA was essentially in line with our forecast, but DCF was above expectations due to timing of maintenance capex. We are maintaining our 2010 and 2011 DCF per unit estimates of $2.30 and $2.80, respectively. Despite headwinds from a low natural gas price environment on domestic demand for contract compression, EXLP's distribution remains secure, in our view. Q1 coverage was 1.2x and the GP remains supportive via potential drop-downs and cost cap adjustments, which help strengthen the partnership's cash flow. With an attractive yield of 8.2% (versus 8.1% for small-cap pipeline MLPs), risk/reward for EXLP remains compelling, in our view.

## Operating Results Essentially In Line

Q1 adjusted EBITDA was $22.4MM versus our estimate of $23.4MM. EPU of $0.05 was slightly below our forecast of $0.08 primarily due to higher-than-anticipated DD&A expense. Q1 results reflect a full-quarter benefit from the $143MM acquisition of 270,000 horsepower (hp) from the partnership's GP sponsor (EXH) completed in November 2009. The benefit from (1) higher-than-expected hp utilization (81% versus our estimate of 78% and 79% in Q4 2009) and (2) slightly lower-than-anticipated SG&A expense of approximately $1MM was more than offset by the impact of a lower adjusted gross margin (i.e. 56% versus our forecast of 58%). Excluding the operating cost cap of $2.8MM, gross margin was 51%.

Management indicated that although domestic hp utilization appears to have stabilized, current depressed natural gas prices pose uncertainty surrounding the timing of a trough and eventual rebound in demand for compression. EXLP's spot utilization rate at the end of Q1 was 80%, down slightly from the average of 81% during Q1. For Q2, we are assuming that activity remains relatively level, with an average utilization rate of 80%. Our model also incorporates a $215MM dropdown acquisition at an EBITDA multiple of 7.5x in Q3 2010.

**Figure 1. Q1 Results**

| *($MM, except per unit data)* | 3/31/09A | 12/31/09A | 3/31/10E | 3/31/10A | ∆ To Est ($) | ∆ To Est (%) |
|---|---|---|---|---|---|---|
| Total revenue | $48.2 | $47.1 | $52.5 | **$52.7** | $0.2 | 0.4% |
| Total cost of sales | $22.2 | $21.3 | $23.4 | **$25.9** | $2.5 | 10.6% |
| Gross profit | $26.1 | $25.8 | $29.1 | **$26.9** | ($2.3) | (7.8%) |
| Gross profit with cost cap | $28.7 | $26.9 | $30.5 | **$29.7** | ($0.8) | (2.7%) |
| Adjusted EBITDA with cost caps | $22.8 | $19.6 | $23.4 | **$22.4** | ($1.0) | (4.3%) |
| Cash interest expense | $4.7 | $5.4 | $6.3 | **$5.4** | ($0.9) | (13.7%) |
| Maintenance capex | $4.7 | $1.3 | $5.0 | **$2.1** | ($2.9) | (57.1%) |
| DCF/unit | $0.67 | $0.58 | $0.48 | **$0.58** | $0.10 | 21.0% |
| Recurring net income | $6.7 | $1.5 | $2.3 | **$1.4** | ($0.8) | (37.3%) |
| Recurring EPU | $0.33 | $0.05 | $0.08 | **$0.05** | ($0.03) | (43.4%) |
| Average diluted units outstanding | 19.1 | 21.8 | 23.9 | **23.9** | 0.0 | 0.0% |
| Distribution declared per unit | $0.4625 | $0.4625 | $0.4625 | **$0.4625** | $0.00 | 0.0% |
| Coverage ratio | 1.43x | 1.14x | 1.04x | **1.24x** | 0.21x | NM |
| Excess cash flow | $4.0 | $1.6 | $0.4 | **$2.8** | $2.4 | NM |

Source: Partnership reports and Wells Fargo Securities, LLC estimates

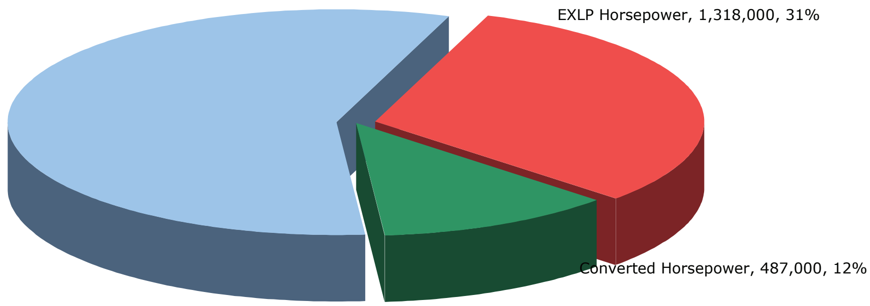
## DCF Higher On Capex Timing But Distribution In Line

Q1 DCF per unit of $0.58 was ahead of our forecast of $0.48 primarily due to lower-than-expected maintenance capex (i.e. $2MM versus our estimate $5MM). As anticipated, EXLP maintained its quarterly distribution of $0.4625 (or $1.85 annualized). Q1 distribution coverage was solid at 1.2x (or excess cash flow of $3MM).

## Contract Conversion Status

At March 31, 2010, Exterran had another 487,000 of horsepower (or 12%) of its total domestic compression business converted to service contracts suitable for the MLP. This compares to 460,000 of horsepower at December 31, 2009. We estimate this immediate dropdown potential to be approximately $390MM (487,000 hp * EBITDA per horsepower of $100 * EBITDA multiple of 8x). Our model currently reflects a $215MM dropdown in Q3 2010, which may prove conservative.

**Figure 2. Contract Conversion Status**




| | 3/31/2010 | 12/31/2009 | 9/30/2009 | 6/30/2009 | 3/31/2009 | 12/31/2008 | 9/30/2008 |
|---|---|---|---|---|---|---|---|
| EXLP Horsepower | 1,318,000 | 1,304,000 | 1,039,000 | 1,034,000 | 1,041,000 | 1,026,000 | 1,017,000 |
| Converted Horsepower | 487,000 | 460,000 | 783,000 | 883,000 | 771,000 | 704,000 | 699,000 |
| Horsepower Not Converted | 2,380,000 | 2,449,000 | 2,411,000 | 2,317,000 | 2,652,000 | 2,729,000 | 2,712,000 |
| **Total HP** | **4,185,000** | **4,213,000** | **4,233,000** | **4,234,000** | **4,464,000** | **4,459,000** | **4,428,000** |

Source: Partnership reports
Note: Exterran's consolidated domestic horsepower totaled 4,185,000 as of 3/31/10

## Balance Sheet Update

As of March 31, 2010, the partnership had $430.5MM of total debt outstanding and annualized debt-to-EBITDA and EBITDA-to-interest expense ratios of 4.8x and 4.1x, respectively. This compares to the small-cap pipeline MLP peer group medians of 4.2x and 4.7x, respectively. The partnership ended Q1 with available borrowing capacity of approximately $32MM on its $315MM credit facility. To note, EXLP's debt covenant thresholds include a maximum debt-to-EBITDA and EBITDA-to-interest expense ratio of 5.0x and 2.5x, respectively. Although EXLP appears to have enough liquidity to fund our 2010 growth capex forecast of $11MM, management is likely to issue equity to strengthen the balance sheet, in our view.

**Figure 3. Overview Of Capital Requirements Versus Sources Of Funding**

| Breakdown Of 2010 Capex | |
|---|---|
| **Total Growth Capex** | **$11** |
| Assumed drop-down acquisition | $215 |
| **Total Debt Maturities** | **$0** |
| **Total Capital Requirements** | **$226** |

| Breakdown Of 2010 Funding | |
|---|---|
| Revolving Credit Facility | $3 |
| Debt Offering to fund 40% of drop-down | $83 |
| **Total Debt Funding** | **$86** |
| Equity Offering to fund 60% of drop-down | $131 |
| Excess Cash Flow | $8 |
| **Total Equity Funding** | **$139** |
| **Total Estimated Funding** | **$226** |
| **Pro Forma 2010E Debt / EBITDA** | **3.4x** |

Source: Wells Fargo Securities, LLC estimates

## Maintaining Our DCF Forecast

We are maintaining our 2010 and 2011 DCF per unit estimates of $2.30 and $2.80, respectively. However, we are lowering our 2010 and 2011 EPU estimates to $0.75 and $1.84, respectively, from $$1.08 and $1.91 to reflect the Q1 variance and higher estimated DD&A expense based on the Q1 2010 run rate. Our 2010 and 2011 distribution forecasts remain $1.90 and $2.04, respectively, which equate to yr/yr increases of approximately 3% and 7%.

**Figure 4. Estimate Changes**

| *($MM, except per unit data)* | **Revised 2010E** | **Previous 2010E** | **Variance** | **Revised 2011E** | **Previous 2011E** | **Variance** |
|---|---|---|---|---|---|---|
| Net Income | **$22** | $32 | (28.8%) | **$67** | $69 | (3.6%) |
| Recurring EPU | **$0.75** | $1.08 | (30.7%) | **$1.84** | $1.91 | (3.8%) |
| Average units outstanding | **26.7** | 26.7 | (0.0%) | **33.5** | 33.5 | (0.1%) |
| Adjusted EBITDA | **$118** | $122 | (3.1%) | **$183** | $183 | (0.2%) |
| Distributable Cash Flow | **$61** | $61 | (0.3%) | **$94** | $94 | 0.0% |
| DCF/unit | **$2.30** | $2.30 | (0.3%) | **$2.80** | $2.80 | 0.1% |
| Distribution per unit | **$1.90** | $1.90 | 0.0% | **$2.04** | $2.04 | 0.0% |
| Coverage ratio | **1.14x** | 1.14x | (0.2%) | **1.27x** | 1.27x | 0.2% |
| Excess cash flow | **$8** | $8 | (2.0%) | **$21** | $21 | 0.6% |

Source: Wells Fargo Securities, LLC estimates

## EXLP Versus Peer Group

The partnership currently provides a yield of 8.2% versus the median of 8.1% for small-cap pipeline MLPs, which also generate primarily fee-based cash flow. EXLP trades at a discount on a price-to-DCF basis (i.e. 9.8x and 8.0x our 2010 and 2011 estimates, respectively, versus 10.1x and 9.6x for the peer group). The partnership trades at a price/DCF-to-growth ratio (analogous to a PEG ratio) of 1.6x, which is below the peer group median of 2.2x.

**Figure 5. EXLP Valuation Metrics**

| | Current | Current | Price/DCF | | Distrib. Growth Est. | | P/DCF To |
|---|---|---|---|---|---|---|---|
| | Price | Yield | 2010E | 2011E | 2010E | 3-Year | Growth Ratio |
| Exterran Partners, LP | $22.44 | 8.2% | 9.8x | 8.0x | 2.8% | 5.1% | 1.6x |
| Small Cap Pipeline MLP Median | | 8.1% | 10.1x | 9.6x | 3.1% | 4.3% | 2.2x |

Source: FactSet and Wells Fargo Securities, LLC; pricing as of 5/6/10 close

**EXTERRAN PARTNERS, L.P. (EXLP)**

*Year ended December 31*
*($ in millions, except for per unit data)*

| | FY2008A | FY2009A | Q1'10A | Q2'10E | Q3'10E | Q4'10E | FY2010E | FY2011E | FY2012E | FY2013E | FY2014E |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Available Horsepower At End Of Period | 1.026 | 1.304 | 1.318 | 1.320 | 1.833 | 1.840 | 1.840 | 2.652 | 3.542 | 4.447 | 4.518 |
| Average Available Horsepower | 0.849 | 1.064 | 1.308 | 1.319 | 1.819 | 1.836 | 1.571 | 2.237 | 3.085 | 3.979 | 4.465 |
| Average Operating Horsepower | 0.846 | 0.878 | 1.060 | 1.044 | 1.531 | 1.541 | 1.294 | 1.871 | 2.557 | 3.266 | 3.563 |
| Utilization | 89.0% | 82.0% | 81.0% | 79.9% | 84.1% | 84.6% | 82.7% | 83.7% | 83.1% | 82.3% | 80.1% |
| **Adjusted EBITDA With Cost Caps** | **86.0** | **81.8** | **22.4** | **22.1** | **35.0** | **38.9** | **118.5** | **182.7** | **240.1** | **302.0** | **342.2** |
| EPU | $1.61 | $0.73 | $0.05 | $0.02 | $0.26 | $0.36 | $0.75 | $1.84 | $1.95 | $1.95 | $1.90 |
| Average Units Outstanding | 17.8 | 19.8 | 23.9 | 23.9 | 29.6 | 29.6 | 26.7 | 33.5 | 41.6 | 49.8 | 53.9 |
| **Distributable Cash Flow (DCF)** | | | | | | | | | | | |
| EBITDA | 86 | 82 | 22 | 22 | 35 | 39 | 118 | 183 | 240 | 302 | 342 |
| Cash Interest Expense | 18 | 20 | 5 | 7 | 9 | 9 | 30 | 43 | 55 | 68 | 76 |
| Other Adjustments | 2 | (0) | 0 | 0 | 0 | 0 | 1 | 1 | 1 | 1 | 1 |
| Maintenance Capex | 9 | 13 | 2 | 5 | 8 | 8 | 23 | 40 | 54 | 69 | 77 |
| **Available Cash Flow** | **57** | **50** | 14 | 10 | 18 | 22 | **64** | **99** | **130** | **163** | **188** |
| General Partner's Interest | 1 | 2 | 1 | 1 | 1 | 1 | 3 | 5 | 10 | 17 | 24 |
| **Distributable Cash Flow (DCF)** | **56** | **48** | **14** | **10** | **17** | **21** | **61** | **94** | **120** | **146** | **164** |
| DCF Per Unit | $3.14 | $2.42 | $0.58 | $0.41 | $0.58 | $0.70 | $2.30 | $2.80 | $2.89 | $2.94 | $3.05 |
| Cash Distribution Declared Per Unit | $1.78 | $1.85 | $0.46 | $0.46 | $0.48 | $0.50 | $1.90 | $2.04 | $2.15 | $2.26 | $2.38 |
| *% sequential growth* | | | *0.0%* | *0.0%* | *3.8%* | *3.6%* | | | | | |
| *% yr/yr growth* | *16.4%* | *4.2%* | *0.0%* | *0.0%* | *3.8%* | *7.6%* | *2.8%* | *7.2%* | *5.1%* | *5.1%* | *5.3%* |
| Distribution Coverage | 1.7x | 1.3x | 1.2x | 0.7x | 1.2x | 1.4x | 1.1x | 1.3x | 1.3x | 1.2x | 1.2x |
| Excess Cash Flow (Deficit) | 23 | 10 | 3 | (4) | 3 | 6 | 8 | 21 | 27 | 29 | 36 |
| **% of Total Cash Distribution** | | | | | | | | | | | |
| General Partner | 3.8% | 4.7% | 4.7% | 4.7% | 5.6% | 6.5% | 5.4% | 7.0% | 9.3% | 12.8% | 15.9% |
| Limited Partners | 96.2% | 95.3% | 95.3% | 95.3% | 94.4% | 93.5% | 94.6% | 93.0% | 90.7% | 87.2% | 84.1% |
| **MPD (Maximum Potential Distribution)** | **$1.91** | **$1.91** | | | | | **$2.11** | **$2.36** | **$2.45** | **$2.54** | **$2.67** |
| **Capital Expenditures** | | | | | | | | | | | |
| Growth Capex | 14 | 5 | 0 | 3 | 4 | 4 | 11 | 20 | 28 | 36 | 41 |
| Maintenance Capex | 9 | 13 | 2 | 5 | 8 | 8 | 23 | 40 | 54 | 69 | 77 |
| Acquisitions (Asset Sales) | 238 | 139 | - | - | 215 | - | 215 | 325 | 353 | 355 | - |
| **Total Capex** | **262** | **156** | 3 | 8 | 227 | 12 | **249** | **384** | **435** | **461** | **118** |
| **Credit and Operating Metrics** | | | | | | | | | | | |
| Equity Issuances *($ in millions)* | 71.7 | 84.1 | - | 131.5 | - | - | 131 | 200 | 221 | 227 | - |
| Total Debt *($ in millions)* | 398.8 | 432.5 | 430.5 | 433.1 | 520.2 | 524.2 | 524.2 | 668.2 | 827.3 | 991.8 | 1,042.8 |
| Debt-to-TTM EBITDA | 4.6x | 4.1x | 5.3x | 5.3x | 5.2x | 4.4x | 4.4x | 3.7x | 3.4x | 3.3x | 3.x |
| TTM EBITDA-to-Interest Expense | 4.8x | 4.1x | 3.8x | 3.6x | 3.7x | 3.9x | 3.9x | 4.2x | 4.3x | 4.4x | 4.5x |
| Maintenance capex as % of EBITDA | 11% | 15% | 10% | 23% | 23% | 21% | 20% | 22% | 23% | 23% | 22% |

Source: Partnership reports and Wells Fargo Securities, LLC estimates
Note: Q2'10 distribution coverage ratio improves to approximately 1x excluding the impact of estimated additional units issued to partially finance our Q3'10 drop-down assumption

## MLP Glossary Of Terms

**Available Cash Flow:** Available cash flow is the cash flow available to the common unitholders and the general partner.

**Backwardation:** A market condition in which future commodity prices are lower than spot prices. A backwardated market usually occurs when demand exceeds supply.

**Contango:** A market condition in which future commodity prices are greater than spot prices. The higher future price is often due to the cost associated with storing and insuring the underlying commodity.

**British Thermal Unit (Btu):** A unit of measurement for energy representing the amount of heat required to raise the temperature of one pound of water one degree Fahrenheit.

**Current Yield:** The current yield is calculated by taking the current declared quarterly distribution annualized and dividing it by current stock price.

**Dekatherm:** A dekatherm is a measurement of energy content. One dekatherm is the approximate energy content of 1,000 cubic feet of natural gas (or 1 Mcf).

**Distributable Cash Flow (DCF):** DCF is the cash flow available to be paid to common unitholders after payments to the general partner.

**Distribution (Dividend) Discount Model (DDM):** DDM is an equity valuation tool used to estimate the present value of a stock based on the expected distributions (or dividends/future cash flow) received from the company.

**Distribution:** In a typical partnership agreement, the MLP is required to distribute all of its "available cash." MLPs typically distribute all available cash flow (i.e. cash flow from operations less maintenance CAPEX) to unitholders in the form of distributions (similar to dividends). However, management typically has some discretion in how much cash flow they choose to pay out.

**Distribution Coverage Ratio:** The coverage ratio indicates the cash available for distribution for every dollar to be distributed. The ratio is calculated by dividing available cash flow by distributions paid. Investors typically associate as the "cushion" a partnership has in paying its cash distribution. In this context, the higher the ratio, the greater the safety of the distribution.

**Dropdown:** A dropdown is the sale of an asset from the parent company (or sponsor company) to the underlying partnership. Dropdowns can also be defined as a transaction between two affiliated companies.

**Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA):** EBITDA is a non-GAAP measure used to provide an approximation of a company's profitability. This measure excludes the potential distortion that accounting and financing rules may have on a company's earnings; therefore, EBITDA is a useful tool when comparing companies that incur large amounts of depreciation expense because it excludes these non-cash items which could understate the company's true performance.

**Earnings Per Unit (EPU):** An MLPs' EPU is synonymous with a C corp.'s earnings per share (EPS). EPU is calculated by dividing net income allocated to the limited partners divided by the weighted average units outstanding at the end of the period.

**EBITDA Multiple:** An EBITDA multiple is the expected return an acquisition or organic growth project is estimated to generate. For example, a $100 million investment at an 8x EBITDA multiple, would be expected to generate approximately $12.5 million of EBITDA on an annual basis (or a 12.5% return).

**Excess Cash Flow:** Excess cash flow is the cash flow that remains after distributions have been paid to common and subordinated unitholders and general partner.

**Fractionation:** Fractionation is the process that involves the separation of the NGLs into discrete NGL purity products (i.e. ethane, propane, normal butane, iso-butane, and natural gasoline).

**Frac Spread (also known as "Processing Margin"):** The processing margin is the difference between the price of natural gas and a composite price for NGLs on a BTU-equivalent basis.

**General Partner (GP):** The GP (1) manages the day-to-day operations of the partnership, (2) generally has a 2% ownership stake in the partnership, and (3) is eligible to receive an incentive distribution (through the ownership of the MLPs' incentive distribution rights).

**Incentive Distribution Rights (IDRs):** IDRs allow the holder (typically the general partner) to receive an increasing percentage of quarterly distributions after the MQD and target distribution thresholds have been achieved. In most partnerships, IDRs can reach a tier wherein the GP is receiving 50% of every incremental dollar paid to the LP unitholders. This is known as the 50/50 or "high splits" tier.

**Limited Partner (LP):** The LP (1) provides capital, (2) has no role in the MLPs' operations or management, and (3) receives cash distributions.

**Liquid Petroleum Gases (LPGs):** LPGs are created (as a byproduct) during the refining of crude oil or from natural gas production. LPGs are typically a mixed form of propane and butane.

**Maintenance Capital Expenditures (CAPEX):** Maintenance CAPEX is the investment required to maintain the partnership's existing asset.

**Natural Gas Liquids (NGLs):** NGLs are extracted from the raw natural gas stream into a liquid mix (consisting of ethane, propane, butane, iso-butane, and natural gasoline). The NGLs are then typically transported via pipelines to fractionation facilities.

**Organic Growth Capital Expenditures (CAPEX):** Organic CAPEX is investments used to expand a company's operating capacity or operating income over the long-term.

**Processing:** Natural gas processing involves the separation of raw natural gas into "pipeline quality" gas and natural gas liquids.

**Tax Deferral Rate:** A percentage of the cash distribution to the unitholder that is tax deferred until the security is sold. The tax deferral rate on distributions ranges from 40-90%. The tax deferral rate is an approximation provided by the partnership and is only effective for a certain period of time.

## Energy Industry Abbreviations

**Bbls:** Barrels

**Bcf/d:** One billion cubic feet per day

**MBtu:** One thousand Btus.

**Mcf:** One thousand cubic feet of natural gas.

**MBbls:** One thousand barrels.

**MBbls/d:** One thousand barrels per day.

**MM:** In millions.

**MMBbls:** One million barrels.

**MMBbls/d:** One million barrels per day.

**MMBtu:** One million Btus.

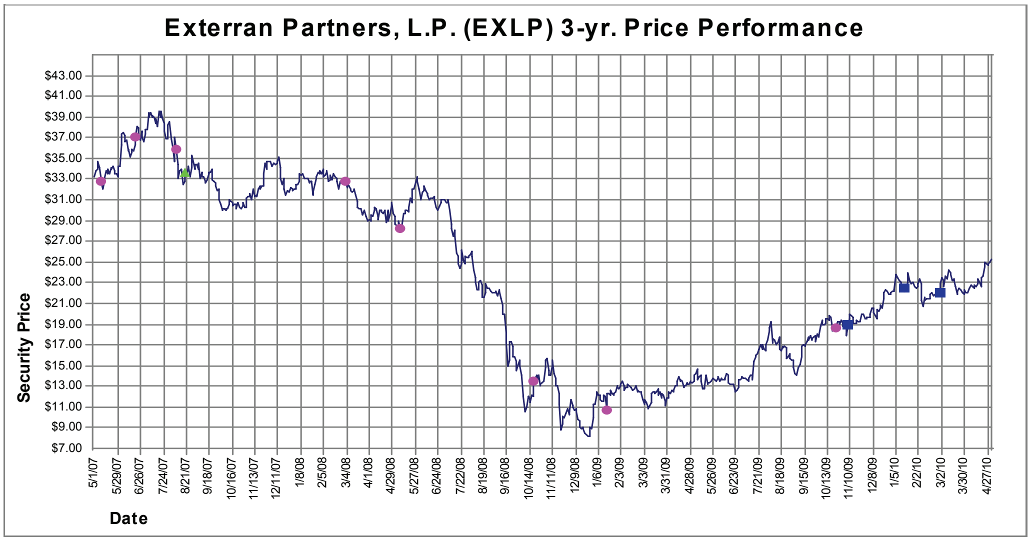
**MMBtu/d:** One million Btus per day.

**MMcf:** One million cubic feet of natural gas.

**MMcf/d:** One million cubic feet of natural gas per day.

**Tcf:** One trillion cubic feet of gas.

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 5/1/2007 | | Lui | | | |
| | 5/1/2007 | NA | 2 | 29.00 | 32.00 | 33.20 |
| ● | 5/9/2007 | NA | 2 | 32.00 | 35.00 | 32.72 |
| ● | 6/20/2007 | NA | 2 | 34.00 | 37.00 | 37.00 |
| ● | 8/8/2007 | NA | 2 | 37.00 | 40.00 | 35.83 |
| ▲ | 8/20/2007 | NA | 1 | NE | NE | 33.63 |
| ● | 3/3/2008 | 32.75 | 1 | 36.00 | 39.00 | 32.70 |
| ● | 5/8/2008 | 28.94 | 1 | 34.00 | 37.00 | 28.25 |
| ● | 10/20/2008 | 11.98 | 1 | 19.00 | 21.00 | 13.50 |
| ● | 1/15/2009 | 12.00 | 1 | 18.00 | 20.00 | 10.70 |
| ● | 10/22/2009 | 18.60 | 1 | 23.00 | 25.00 | 18.70 |
| ■ | 11/6/2009 | | Lui | | | |
| ■ | 1/15/2010 | | Blum | | | |
| ● | 1/15/2010 | 22.43 | 1 | 25.00 | 27.00 | 22.42 |
| ■ | 2/26/2010 | | Lui | | | |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- □ Split Adjustment

**Rating Code Key**
- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
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As of: May 7, 2010

| | |
|---|---|
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May 7, 2010

# *Equity Research*

WELLS FARGO SECURITIES

## CGI Group Acquiring Stanley For $37.50 In Cash

**Values SXE (On CY11) At 16.7x P/E And 9.7x EV/EBITDA**
**DCP, Now SXE--Clearly Government Services Sector Continues To Consolidate**

Sector Rating: Global Service Providers, Market Weight
Sector Rating: Government Services Providers, Market Weight

| | | Price | FY EPS | | FY P/E | |
|---|---|---|---|---|---|---|
| **Company Name** | **Rati** | **05/06** | **2010E** | **2011E** | **2010** | **2011** |
| **Global Service Providers** | | | | | | |
| Accenture plc (ACN) | 2 | $41.09 | $2.65 | $2.98 | 15.5x | 13.8x |
| CGI Group, Inc. (GIB) | 1 V | 14.44 | 1.12 | 1.27 | 12.9x | 11.4x |
| Computer Sciences | 2 | 50.27 | 5.10 | 5.25 | 9.9x | 9.6x |
| **Government Services Providers** | | | | | | |
| CACI International Inc. | 2 | 47.18 | 3.43 | 3.75 | 13.8x | 12.6x |
| DynCorp International, Inc. | 2 V | 17.02 | 1.39 | 1.75 | 12.2x | 9.7x |
| ICF International, Inc. | 2 | 22.00 | 1.39 | 1.71 | 15.8x | 12.9x |
| ManTech International | 1 | 43.73 | 3.45 | 3.85 | 12.7x | 11.4x |
| NCI, Inc. (NCIT) | 2 V | 21.78 | 1.62 | 1.78 | 13.4x | 12.2x |
| SAIC, Inc. (SAI) | 2 | 17.29 | 1.24 A | 1.31 | 13.9x | 13.2x |
| SRA International, Inc. | 2 V | 22.05 | 1.26 | 1.37 | 17.5x | 16.1x |
| Stanley, Inc. (SXE) | 1 V | 29.00 | 1.90 | 2.05 | 15.3x | 14.2x |

*Source: Company data and Wells Fargo Securities, LLC estimates 1= Outperform, 2 = Market Perform, 3 = Underperform, V = Volatile NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*


- **SUMMARY.** CGI Group (GIB) announced a definitive agreement to acquire Stanley (SXE) for $37.50 per share in cash. This is a valuation level several multiple points above the current government services group trading range, although (in our view) SXE has the best business momentum currently. We expect the consolidation trend to continue, but we note that most publicly traded providers have a controlling shareholder and/or super-voting rights.


- **Transaction Details.** The transaction, which is expected to close in the fall after completing what appears to be normal approval process, values SXE at a little over $1 billion. GIB indicated it will use cash on hand and existing financing arrangements to fund the deal. GIB is holding a conference call at 8:30am (ET)...888-789-9572...passcode 750086#.

- **Implied Valuation.** Based on our estimates, the transaction values SXE at 16.7x CY2011 EPS ($37.50/$2.25), and an enterprise value/EBITDA of 9.7x ($1.038B/$107MM). Based on Wednesday night's (5/5) close (i.e. before the market chaos), government service providers had P/Es on CY2011E of 12-15x and EV/EBITDAs on CY2011 of 6.0-8.2x. Based on Thursday's close (5/6), CY2011 P/E range is 11-15x and EV/EBITDA range is 5.5-7.8x. Valuation tables are attached.

- **Confirms Consolidating Industry Trend.** Private equity firm Cerberus recently announced an intent to acquire DynCorp (DCP) and now GIB is acquiring SXE. We note a long list of former public government service providers, including AMS, Anteon, SI International, SystemsNet, and Veridian.


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**Please see page 6 for rating definitions, important disclosures and required analyst certifications**

**Wells Fargo Securities, LLC Equity Research**
**Selected Federal Government-Focused Information Technology (IT) Services Providers**
**Summary Valuation**
($ in millions, except per share data)

| Company | Price 5/6/10 | Mkt. Cap. | Net Debt | Enter. Value | CY EPS 2010E | CY EPS 2011E | Rev. Growth CY10E | Rev. Growth CY11E | CY P/E 2010E | CY P/E 2011E | Est. 3-5yr LTGR | P/E/ LTGR 2010E | Enterprise Value/ Rev. LTM | Enterprise Value/ EBITDA LTM | Ticker |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Federal Government IT Integrators** | | | | | | | | | | | | | | | |
| CACI International | $47.18 | $1,420 | $354 | $1,775 | $3.60 | $3.90 | 11% | 6% | 13.1x | 12.1x | 12% | 1.1 | 0.6 | 7.3 | CACI |
| Dynamics Research | 12.36 | 123 | 32 | 155 | 1.21 | 1.33 | 5 | 4 | 10.2 | 9.3 | 12 | 0.8 | 0.6 | 6.2 | DRCO |
| DynCorp International Inc. | 17.02 | 958 | 485 | 1,443 | 1.60 | 1.82 | 11 | 4 | 10.6 | 9.4 | 10 | 1.1 | 0.4 | 6.3 | DCP |
| Global Defense Technology & Systems | 13.68 | 124 | 4 | 128 | 0.97 | 1.21 | 15 | 14 | 14.1 | 11.3 | 18 | 0.8 | 0.6 | 9.3 | GTEC |
| ICF International, Inc. | 22.00 | 425 | 128 | 553 | 1.39 | 1.71 | 13 | 12 | 15.8 | 12.9 | 15 | 1.1 | 0.8 | 8.9 | ICFI |
| ManTech International | 43.73 | 1,583 | 103 | 1,686 | 3.45 | 3.85 | 34 | 13 | 12.7 | 11.4 | 12 | 1.1 | 0.8 | 7.9 | MANT |
| NCI, Inc. | 21.78 | 296 | 30 | 326 | 1.62 | 1.78 | 17 | 12 | 13.4 | 12.2 | 15 | 0.9 | 0.7 | 7.6 | NCIT |
| SAIC, Inc. | 17.29 | 6,690 | 245 | 6,935 | 1.31 | 1.43 | 4 | 5 | 13.2 | 12.1 | 10 | 1.3 | 0.6 | 7.2 | SAI |
| SRA International | 22.05 | 1,252 | 19 | 1,271 | 1.27 | 1.47 | 4 | 12 | 17.4 | 15.0 | 10 | 1.7 | 0.8 | 8.3 | SRX |
| Stanley, Inc. | 29.00 | 699 | 135 | 834 | 1.96 | 2.25 | 6 | 14 | 14.8 | 12.9 | 15 | 1.0 | 1.0 | 9.4 | SXE |
| **State Government IT Integrators** | | | | | | | | | | | | | | | |
| Maximus Inc. | 60.79 | 1,057 | (125) | 932 | 3.51 | NE | 12 | 9 | 17.3 | NM | NE | NM | 1.2 | 9.4 | MMS |
| Tier Technologies | 7.95 | 144 | (29) | 115 | 0.10 | NE | 5 | NE | 83.7 | NM | 15 | 5.6 | 0.9 | 37.2 | TIER |
| **Large IT Consultants/ Apps Outsourcers** | | | | | | | | | | | | | | | |
| Accenture | 41.09 | 29,174 | (4,114) | 25,060 | 2.72 | 3.05 | 5 | 6 | 15.1 | 13.5 | 12 | 1.3 | 1.2 | 8.9 | ACN |
| Computer Sciences Corporation | 50.27 | 7,721 | 1,880 | 9,601 | 5.07 | NE | 5 | NE | 9.9 | NM | 10 | 1.0 | 0.6 | 4.1 | CSC |

**Notes:**
The long-term growth rate represents the increase in EPS expected over a 3-5-year period in a normalized environment.
ACN and DRCO are EBITA estimates.
DCP and TIER are adjusted EBITDA estimates.
Balance sheet data is as of the last reported quarter.
The estimates for GTEC, DRCO, MMS, TIER represent Wall Street consensus estimates. All other estimates are Wells Fargo Securities, LLC estimates.
ACN, CSC joint coverage with Eric Boyer (443) 263-6559

Source: Wells Fargo Securities, LLC estimates, company reports, FactSet, and First Call

**Wells Fargo Securities, LLC Equity Research**
**Selected Federal Government-Focused Information Technology (IT) Services Providers**
**Summary Valuation-Enterprise Value**

($ in millions, except per share data)

| Company | Price 5/6/10 | Enter. Value | Net Debt | Op. Margin CY10E | Op. Margin CY11E | EBITDA Margin CY10E | EBITDA Margin CY11E | Ent. Value/EBITDA CY10E | Ent. Value/EBITDA CY11E | Ent. Value/Rev. CY10E | Ent. Value/Rev. CY11E | Book Value Per Share | Ticker |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Federal Government IT Integrators** | | | | | | | | | | | | | |
| CACI International | $47.18 | $1,775 | $354 | 6.4% | 6.7% | 8.1% | 8.4% | 6.8 | 6.2 | 0.5 | 0.5 | $37.48 | CACI |
| Dynamics Research | 12.36 | 155 | 32 | 7.4 | 7.7 | 9.9 | 10.3 | 5.9 | 5.7 | 0.5 | 0.5 | 9.48 | DRCO |
| DynCorp International Inc. | 17.02 | 1,443 | 485 | 5.7 | 6.0 | 6.6 | 6.9 | 5.9 | 5.4 | 0.4 | 0.4 | 9.98 | DCP |
| Global Defense Technology & Systems | 13.68 | 128 | 4 | 6.1 | 6.7 | 8.1 | 8.2 | 8.1 | 7.1 | 0.5 | 0.5 | 9.41 | GTEC |
| ICF International, Inc. | 22.00 | 553 | 128 | 6.6 | 7.4 | 9.7 | 9.8 | 7.5 | 6.7 | 0.7 | 0.7 | 16.84 | ICFI |
| ManTech International | 43.73 | 1,686 | 103 | 7.9 | 8.0 | 9.4 | 9.3 | 6.6 | 5.9 | 0.6 | 0.6 | 23.63 | MANT |
| NCI, Inc. | 21.78 | 326 | 30 | 6.9 | 7.0 | 7.7 | 7.7 | 7.7 | 6.9 | 0.6 | 0.5 | 9.71 | NCIT |
| SAIC, Inc. | 17.29 | 6,935 | 245 | 7.9 | 8.2 | 8.8 | 9.0 | 7.0 | 6.5 | 0.6 | 0.6 | 5.92 | SAI |
| SRA International | 22.05 | 1,271 | 19 | 7.3 | 7.7 | 9.7 | 9.9 | 7.8 | 6.8 | 0.8 | 0.7 | 13.82 | SRX |
| Stanley, Inc. | 29.00 | 834 | 135 | 9.0 | 9.1 | 10.3 | 10.3 | 8.9 | 7.8 | 0.9 | 0.8 | 10.92 | SXE |
| **State Government IT Integrators** | | | | | | | | | | | | | |
| Maximus Inc. | 60.79 | 932 | (125) | 11.9 | NE | 14.2 | NE | 8.6 | 7.9 | 1.1 | 1.0 | 17.43 | MMS |
| Tier Technologies | 7.95 | 115 | (29) | 0.9 | NE | 7.3 | NE | 35.5 | NM | 0.8 | NM | 5.04 | TIER |
| **Large IT Consultants/ Apps Outsourcers** | | | | | | | | | | | | | |
| Accenture | 41.09 | 25,060 | (4,114) | 13.4 | 13.6 | 13.4 | 13.6 | 8.5 | 7.9 | 1.1 | 1.1 | 4.17 | ACN |
| Computer Sciences Corporation | 50.27 | 9,601 | 1,880 | 8.8 | NE | 14.9 | NE | 3.8 | NM | 0.6 | NM | 43.49 | CSC |

**Notes:**
ACN and DRCO are EBITA estimates.
DCP and TIER are adjusted EBITDA estimates.
Balance sheet data is as of the last reported quarter.
The estimates for GTEC, DRCO, MMS, TIER represent Wall Street consensus estimates. All other estimates are Wells Fargo Securities, LLC estimates.
ACN, CSC joint coverage with Eric Boyer (443) 263-6559

Source: First Call, FactSet, and Wells Fargo Securities, LLC estimates

PEO-STRI $40mm FY11 growover, or about 5 pts

**Stanley, Inc.**
**Annual Earnings Statement, (March) FY2006-12E and CY2009-11E**
($ in thousands, except per share data)

| | FY2006 | FY2007 | FY2008 | FY2009 | FY2010E | FY2011E | FY2012E | CY2009 | CY2010E | CY2011E |
|---|---|---|---|---|---|---|---|---|---|---|
| | (Mar 06) | (Mar 07) | (Mar 08) | (Mar 09) | (Mar 10) | (Mar 11) | (Mar 11) | | | |
| | | | | Guidance: | $868-876mm | | | | | |
| **Revenue** | **$284,801** | **$409,411** | **$604,342** | **$779,678** | **$873,858** | **$950,000** | **$1,065,000** | **$865,295** | **$916,000** | **$1,040,000** |
| Cost of revenue | 248,260 | 349,647 | 512,250 | 653,673 | 728,241 | 793,350 | 890,375 | 721,824 | 764,229 | 869,450 |
| Gross Profit | 36,541 | 59,764 | 92,092 | 126,005 | 145,617 | 156,650 | 174,625 | 143,471 | 151,771 | 170,550 |
| Selling, general & administrative | 12,806 | 24,686 | 37,236 | 49,114 | 55,431 | 58,535 | 64,610 | 54,298 | 57,634 | 63,415 |
| **EBITDA** | **23,735** | **35,078** | **54,856** | **76,891** | **90,186** | **98,115** | **110,015** | **89,173** | **94,137** | **107,135** |
| Amortization of deferred compensation | 790 | 954 | 266 | 248 | 0 | 0 | 0 | 62 | 0 | 0 |
| Depreciation & Amortization | 3,057 | 5,418 | 6,695 | 9,988 | 11,477 | 11,900 | 12,500 | 11,521 | 11,800 | 12,300 |
| Other | 3,590 | 4,129 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **Operating income** | **16,298** | **24,577** | **47,895** | **66,655** | **78,709** | **86,215** | **97,515** | **77,590** | **82,337** | **94,835** |
| Net Interest income (expense) | (2,441) | (5,914) | (3,778) | (5,396) | (3,744) | (3,250) | (2,850) | (4,125) | (3,350) | (2,950) |
| Other income | 101 | (481) | 19 | 26 | 3 | 0 | 0 | 9 | 0 | 0 |
| Pretax income | 13,958 | 18,182 | 44,136 | 61,285 | 74,968 | 82,965 | 94,665 | 73,474 | 78,987 | 91,885 |
| Income tax expense | 5,708 | 7,477 | 17,972 | 24,054 | 29,380 | 32,771 | 37,393 | 28,713 | 31,219 | 36,295 |
| **Net income** | **8,250** | **10,705** | **26,164** | **37,231** | **45,588** | **50,194** | **57,272** | **44,761** | **47,768** | **55,590** |
| EPS (pro forma) | $0.74 | $0.68 | $1.12 | $1.56 | $1.90 | $2.05 | $2.30 | $1.87 | $1.96 | $2.05 |
| **EPS (GAAP, diluted)** | **0.51** | **0.55** | **1.12** | **1.56** | **1.90** | **2.05** | **2.30** | **1.87** | **1.96** | **2.25** |
| | | | | Guidance (GAAP): | $1.87-1.89 | | | | | |
| Avg. no. of shares--diluted | 16,096 | 19,500 | 23,414 | 23,814 | 24,047 | 24,450 | 24,850 | 23,953 | 24,350 | 24,750 |
| **Yr/Yr % increase:** | | | | | | | | | | |
| **Revenue** | **1%** | **44%** | **48%** | **29%** | **12%** | **9%** | **12%** | **17%** | **6%** | **14%** |
| *Organic growth* | *NA* | *18%* | *37%* | *19%* | *8%* | *9%* | *11%* | *NA* | *NA* | *NA* |
| EBITDA | 8 | 48 | 56 | 40 | 17 | 9 | 12 | 25 | 6 | 14 |
| Operating income | (15) | 51 | 95 | 39 | 18 | 10 | 13 | 25 | 6 | 15 |
| Avg. no. of diluted shares | (0) | 21 | 20 | 2 | 1 | 2 | 2 | 1 | 2 | 2 |
| Gross Margin | 12.8% | 14.6% | 15.2% | 16.2% | 16.7% | 16.5% | 16.4% | 16.6% | 16.6% | 16.4% |
| SG&A expense/revenue | 4.5 | 6.0 | 6.2 | 6.3 | 6.3 | 6.2 | 6.1 | 6.3 | 6.3 | 6.1 |
| **EBITDA margin** | **8.3** | **8.6** | **9.1** | **9.9** | **10.3** | **10.3** | **10.3** | **10.3** | **10.0** | **10.3** |
| D&A/revenue | 1.1 | 1.3 | 1.1 | 1.3 | 1.3 | 1.3 | 1.2 | 1.3 | 1.3 | 1.2 |
| **Operating margin** | **5.7** | **6.0** | **7.9** | **8.5** | **9.0** | **9.1** | **9.2** | **9.0** | **9.0** | **9.1** |
| Pretax margin | 4.9 | 4.4 | 7.3 | 7.9 | 8.6 | 8.7 | 8.9 | 8.5 | 8.6 | 8.8 |
| Tax rate | 40.9 | 41.1 | 40.7 | 39.2 | 39.2 | 39.5 | 39.5 | 39.1 | 39.5 | 39.5 |

Source: Company data and Wells Fargo Securities LLC estimates

**Stanley, Inc.**
**Quarterly Earnings Model, FY2009-11E**
($ in thousands, except per share data)

| | FQ1 2009 (Jun08) | FQ2 2009 (Sep08) | FQ3 2009 (Dec08) | FQ4 2009 (Mar09) | FQ1 2010 (Jun09) | FQ2 2010 (Sep09) | FQ3 2010 (Dec09) | FQ4 2010E (Mar10) | FQ1 2011E (Jun10) | FQ2 2011E (Sep10) | FQ3 2011E (Dec10) | FQ4 2011E (Mar11) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Guidance: | $160-168mm | $184-192mm | $195-202 mm | $206-213mm | $206-215mm | $206-213mm | $212-219mm | $215-223mm | | | | |
| **Revenue** | **$172,566** | **$191,078** | **$203,597** | **$212,437** | **$208,747** | **$217,089** | **$227,022** | **$221,000** | **$220,000** | **$230,000** | **$245,000** | **$255,000** |
| Cost of revenue | 145,760 | 159,925 | 170,091 | 177,897 | 173,089 | 180,518 | 190,320 | 184,314 | 183,260 | 191,590 | 205,065 | 213,435 |
| Gross Profit | 26,806 | 31,153 | 33,506 | 34,540 | 35,658 | 36,571 | 36,702 | 36,686 | 36,740 | 38,410 | 39,935 | 41,565 |
| Selling, general & administrative | 10,659 | 12,224 | 13,220 | 13,011 | 14,092 | 13,401 | 13,794 | 14,144 | 14,300 | 14,490 | 14,700 | 15,045 |
| **EBITDA** | **16,147** | **18,929** | **20,286** | **21,529** | **21,566** | **23,170** | **22,908** | **22,542** | **22,440** | **23,920** | **25,235** | **26,520** |
| Amort. of IPO related comp | 62 | 62 | 62 | 62 | NA | NA | NA | NA | NA | NA | NA | NA |
| Depreciation & Amortization | 1,779 | 2,524 | 2,741 | 2,944 | 2,830 | 2,852 | 2,895 | 2,900 | 2,950 | 2,950 | 3,000 | 3,000 |
| Other | | - | - | - | | - | - | - | - | - | - | - |
| **Operating income** | **14,306** | **16,343** | **17,483** | **18,523** | **18,736** | **20,318** | **20,013** | **19,642** | **19,490** | **20,970** | **22,235** | **23,520** |
| Net Interest income (expense) | (411) | (1,759) | (1,970) | (1,256) | (1,110) | (876) | (883) | (875) | (850) | (825) | (800) | (775) |
| Other income | 2 | 1 | 17 | 6 | 3 | - | - | - | - | - | - | - |
| Pretax income | 13,897 | 14,585 | 15,530 | 17,273 | 17,629 | 19,442 | 19,130 | 18,767 | 18,640 | 20,145 | 21,435 | 22,745 |
| Income tax expense | 5,580 | 5,857 | 5,852 | 6,765 | 6,965 | 7,689 | 7,294 | 7,432 | 7,363 | 7,957 | 8,467 | 8,984 |
| **Net income** | **8,317** | **8,728** | **9,678** | **10,508** | **10,664** | **11,753** | **11,836** | **11,335** | **11,277** | **12,188** | **12,968** | **13,761** |
| | | | FY (GAAP): | 1.56 | | | FY (GAAP): | $1.90 | | | FY (GAAP): | $2.05 |
| EPS (pro forma) | $0.35 | $0.37 | $0.41 | $0.44 | $0.45 | $0.49 | $0.49 | $0.47 | $0.46 | $0.50 | $0.53 | $0.56 |
| **EPS (GAAP, diluted)** | **0.35** | **0.37** | **0.41** | **0.44** | **0.45** | **0.49** | **0.49** | **0.47** | **0.46** | **0.50** | **0.53** | **0.56** |
| Guidance (GAAP): | $0.30-0.32 | $0.31-0.33 | $0.35-37 | $0.41-0.43 | $0.41-0.43 | $0.41-0.43 | $0.46-0.48 | $0.46-0.48 | | | | |
| Avg. no. of shares--diluted | 23,649 | 23,817 | 23,818 | 23,823 | 23,844 | 24,058 | 24,086 | 24,200 | 24,300 | 24,400 | 24,500 | 24,600 |
| **Yr/Yr % increase:** | | | | | | | | <<< | ------------- Reflects PEO STRI ($40mm/yr) Growc | | | |
| **Revenue** | **29%** | **27%** | **38%** | **22%** | **21%** | **14%** | **12%** | **4%** | **5%** | **6%** | **8%** | **15%** |
| Organic growth | *29* | *17* | *24* | *10* | *5* | *11* | *12* | *4* | *5* | *6* | *8* | *15* |
| EBITDA | 38 | 42 | 45 | 36 | 34 | 22 | 13 | 5 | 4 | 3 | 10 | 18 |
| Operating income | 42 | 41 | 43 | 32 | 31 | 24 | 14 | 6 | 4 | 3 | 11 | 20 |
| Avg. no. of diluted shares | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 2 | 2 | 1 | 2 | 2 |
| Gross Margin | 15.5% | 16.3% | 16.5% | 16.3% | 17.1% | 16.8% | 16.2% | 16.6% | 16.7% | 16.7% | 16.3% | 16.3% |
| SG&A expense/revenue | 6.2 | 6.4 | 6.5 | 6.1 | 6.8 | 6.2 | 6.1 | 6.4 | 6.5 | 6.3 | 6.0 | 5.9 |
| **EBITDA margin** | **9.4** | **9.9** | **10.0** | **10.1** | **10.3** | **10.7** | **10.1** | **10.2** | **10.2** | **10.4** | **10.3** | **10.4** |
| D&A/revenue | 1.0 | 1.3 | 1.3 | 1.4 | 1.4 | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 | 1.2 | 1.2 |
| **Operating margin** | **8.3** | **8.6** | **8.6** | **8.7** | **9.0** | **9.4** | **8.8** | **8.9** | **8.9** | **9.1** | **9.1** | **9.2** |
| Pretax margin | 8.1 | 7.6 | 7.6 | 8.1 | 8.4 | 9.0 | 8.4 | 8.5 | 8.5 | 8.8 | 8.7 | 8.9 |
| Tax rate | 40.2 | 40.2 | 37.7 | 39.2 | 39.5 | 39.5 | 38.1 | 39.6 | 39.5 | 39.5 | 39.5 | 39.5 |

Source: Company data and Wells Fargo Securities, LLC estimates

# Required Disclosures

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- Wells Fargo Securities, LLC or its affiliates intends to seek or expects to receive compensation for investment banking services in the next three months from Computer Sciences Corporation, DynCorp International, Inc., ManTech International Corporation, SAIC, Inc., SRA International, Inc., Stanley, Inc.
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- Wells Fargo Securities, LLC and/or its affiliates, have beneficial ownership of 1% or more of any class of the common stock of DynCorp International, Inc., ICF International, Inc.
- DynCorp International, Inc. currently is, or during the 12-month period preceding the date of distribution of the research report was, a client of Wells Fargo Securities, LLC. Wells Fargo Securities, LLC provided investment banking services to DynCorp International, Inc.
- DynCorp International, Inc. currently is, or during the 12-month period preceding the date of distribution of the research report was, a client of Wells Fargo Securities, LLC. Wells Fargo Securities, LLC provided nonsecurities services to DynCorp International, Inc.
- Wells Fargo Securities, LLC received compensation for products or services other than investment banking services from DynCorp International, Inc. in the past 12 months.
- Wells Fargo Securities, LLC, or any of its affiliates, has beneficial ownership of 6.1% of any class of common stock of ICF International, Inc.

**ACN:** Risks include an extended period of slow economic activity and therefore IT driven investment, delayed recovery of the outsourcing business, increased competition from both domestic and offshore service providers, and growing uncertainty of when and if operating margin will again turn up, although management is now indicating several signs of bottoming/recovery.
**CACI:** Risks include historic reliance on more "pass-through" related revenue growth which has a dampening impact on operating margin and generates more quarterly volatility to results, as well as relatively higher financial leverage.
**CSC:** The primary risks to our thesis are CSC's execution on its UK NHS project, and the impact of the economy on discretionary spending and longer-term deal signings. Other factors are a highly competitive ITO market, offshore cannibalization, and execution issues.
**DCP:** Risks include a reliance on the timing of government funding and timing of project ramps, therefore a history/expectation of rather uneven revenue and earnings. Ramp up of LOGCAP IV task orders (and associated revenue recognition timing), increased uncertainty around CIVPOL (police training) related work, and a small chance of fallout from the self-reported possible FCPA violation.
**GIB:** Risks to our valuation range include a weak economy, revenue concentration with BCE, acquisition integration.
**ICFI:** Risks to our valuation include the uneven timing of government funding, prolonged weakness in demand from ICF's commercial and state/local markets, a rapidly growing federal deficit, and relatively higher financial leverage.
**MANT:** Risks include exposure and uncertain timing of in-theatre support contracts (about 25-30% of revenue), acquisition assimilation, concentrated ownership with two classes of stock impacting voting power, and the vagaries of having the U.S. federal government as a client.
**NCIT:** Risks include the uneven timing of government funding, still uncertain priorities for the Obama Administration, budget funding pressure from continued efforts in Iraq and Afghanistan, and a rapidly growing federal deficit given the economic downturn. In addition, there will be more uneven timing from an increased reliance on pass-through revenue. Also, though the founder has reduced his stake to about 20%, he still controls more than 80% of the voting rights.
**SAI:** Risks include timing of federal outlays, delays or directional change related to the new Obama administration, including expected increase in oversight/audit, and uneven timing of higher margin product ("VACIS") sales.
**SRX:** Risks include the vagaries of having the U.S. federal government as a client, increasing competition especially as pursued deals get larger, large re-compete exposure in FY10, acquisition assimilation, and potential share overhang from the founder.
**SXE:** Risks include the uneven timing of federal outlays especially during this period of Administration change uncertainty, as well as acquisition assimilation on potential deals that appear more likely. SXE faces a FY11 growover challenge from the PEO STRI contract.

Wells Fargo Securities, LLC does not compensate its research analysts based on specific investment banking transactions. Wells Fargo Securities, LLC's research analysts receive compensation that is based upon and impacted by the overall profitability and revenue of the firm, which includes, but is not limited to investment banking revenue.

## *STOCK RATING*

**1=Outperform**: The stock appears attractively valued, and we believe the stock's total return will exceed that of the market over the next 12 months. BUY
**2=Market Perform**: The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD
**3=Underperform**: The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

## *SECTOR RATING*

**O=Overweight**: Industry expected to outperform the relevant broad market benchmark over the next 12 months.
**M=Market Weight**: Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.
**U=Underweight**: Industry expected to underperform the relevant broad market benchmark over the next 12 months.

## *VOLATILITY RATING*

**V** = A stock is defined as volatile if the stock price has fluctuated by +/-20% or greater in at least 8 of the past 24 months or if the analyst expects significant volatility. All IPO stocks are automatically rated volatile within the first 24 months of trading.

**As of: May 7, 2010**

| | |
|---|---|
| 45% of companies covered by Wells Fargo Securities, LLC Equity Research are rated Outperform. | Wells Fargo Securities, LLC has provided investment banking services for 42% of its Equity Research Outperform-rated companies. |
| 50% of companies covered by Wells Fargo Securities, LLC Equity Research are rated Market Perform. | Wells Fargo Securities, LLC has provided investment banking services for 41% of its Equity Research Market Perform-rated companies. |
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May 7, 2010

*Equity Research*

# Wells Fargo Securities' Weekly Services Monitor

**CGI Acquiring SXE Continuing Consolidation In Gov't Services**
**CTSH Strong Qtr/Guidance; Customer Care Disappoints**

- **HIGHLIGHTS OF THE WEEK - Outsourcing, Systems Integration &Consulting.** CGI Group (GIB, GIB.A) is acquiring U.S. Federal Government Services provider Stanley (SXE) for approx. $1bn. The customer care providers continue to report disappointing results as TeleTech (TTEC) and StarTek (SRT) both missed numbers and lowered their outlooks due to greater than expected volume declines. Hewitt (HEW) reported a strong quarter and maintained guidance. Diamond (DTPI) reported better than expected FQ4 and initial FY11 guidance. We raised our estimates and took up our investment rating to Outperform from Market Perform for this small cap early cycle play on a U.S. economic recovery. Sapient (SAPE) reported a slightly better Q1 and then re-affirmed CY10 and CY11 guidance.

- **HIGHLIGHTS OF THE WEEK - Offshore.** Cognizant (CTSH) reported better than expected CQ1 results and expanded further CY10 revenue guidance to a sector leading 25% plus. While still expressing some caution on the pace of business recovery, especially for discretionary spending, the signs of improvement are growing. We raised our revenue and EPS estimates and enthusiastically reiterate our Outperform rating, especially in this uncertain stock market.

- **HIGHLIGHTS OF THE WEEK - Government.** While the excitement of the week was the GIB-SXE offer, there were some earnings reports as well. NCI (NCIT) reported in-line results, but guided lower on stepped-up new business and infrastructure investments and an unfavorable revenue mix shift. The stock was hit hard in response. After backing out several one-time items, SRA (SRX) reported essentially in-line FQ3 results, and offered FQ4 guidance close to prior expectations.

- **THE WEEK AHEAD.** In the government services space, small cap Global Tech (GTEC) reports Monday after the close and privately held Vangent reports Tuesday morning. Government consultant ICFI Int'l (ICFI) holds its first ever analyst meeting in New York City on Tuesday. IBM is having its "investor briefing" in New York City on Wednesday.

- **INVESTMENT FOCUS – Government Services, in general.** Given the proposed acquisition of DynCorp (DCP) by Cerberus and now the proposed acquisition of Stanley (SXE) by CGI Group (GIB), we believe that the government services group should enjoy an upward bias even with ongoing award decision delays limiting revenue upside potential in the near-term.

- Information Technology (IT) Services


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**Please see page 11 for rating definitions, important disclosures and required analyst certifications**

## MARKET INDICES (4/30/10-5/6/10)

| Services Indices | Period | YTD | Indices | Period | YTD |
|---|---|---|---|---|---|
| Global Services | (5%) | (4%) | DJIA | (4%) | 1% |
| Gov't Integrators | (5%) | 2% | COMP | (6%) | 2% |
| Offshore IT/BPO | (5%) | (5%) | SP500 | (5%) | 1% |
| Staffing & Recruiting | (5%) | 4% | SPMID | (6%) | 7% |
| IT Consulting | (7%) | 6% | | | |
| Customer Care | (9%) | (13%) | | | |

Offshore IT/BPO: CTSH, G, EXLS, INFY, SYNT, WIT, WNS. Government Integrators: CAI, DCP, MANT, MMS, NCIT, SAI, SRX, SXE. IT Consulting: ACN, CBR, DTPI, SAPE. Global Services: ACN, CSC, GIB, HPQ, IBM. Customer Care: CVG, SRT, SYKE, TTEC. Staffing & Recruiting: HHGP, HSII, KELYA, KFY, LRW, MAN, MNST, RHI, SFN, WW

Source: Wells Fargo Securities, LLC, FactSet

## RESEARCH COMMENTS – Government

### CGI Group (GIB, Outperform, $14.37)
### Stanley (SXE, Outperform, $36.82)
### CGI Group Acquiring Stanley For $37.50 In Cash

*Values SXE (On CY11) At 16.7x P/E And 9.7x EV/EBITDA*
*DCP, Now SXE--Clearly Government Services Sector Continues To Consolidate*

**GIB announced a definitive agreement to acquire SXE for $37.50 per share in cash.** This is a valuation level several multiple points above the current government services group trading range, although (in our view) SXE has the best business momentum currently. We expect the consolidation trend to continue, but we note that most publicly traded providers have a controlling shareholder and/or super-voting rights.

**Transaction Details.** The transaction, which is expected to close in the fall after completing what appears to be a normal approval process, values SXE at a little over $1bn. GIB indicated it will use cash on hand and existing financing arrangements to fund the deal.

**Implied Valuation.** Based on our estimates, the transaction values SXE at 16.7x CY2011 EPS ($37.50/$2.25), and an enterprise value/EBITDA of 9.7x ($1.038B/$107mm). Based on Wednesday night's (5/5) close (i.e. before the market chaos), government service providers had P/Es on CY2011E of 12-15x and EV/EBITDAs on CY2011 of 6.0-8.2x. Based on Thursday's close (5/6), CY2011 P/E range is 11-15x and EV/EBITDA range is 5.5-7.8x.

**Confirms Consolidating Industry Trend.** Private equity firm Cerberus recently announced an intent to acquire DynCorp (DCP, Market Perform, $16.80) and now GIB is acquiring SXE. We note a long list of former public government service providers, including AMS, Anteon, SI International, SystemsNet, and Veridian.

### ICF International (ICFI, Market Perform, $22.09)
### Q1 EPS Essentially In-line On Strong Organic Growth

*2010 Guidance Reaffirmed, Fine Tuning Estimates Higher*

**Q1 Results As Expected; 2010 Guidance Reaffirmed.** ICFI reported Q1 revenue of $174mm, up 18% on a "core" organic basis. EPS of $0.28 was within guided range although a penny below consensus. 2010 guidance of 11-16% organic growth and EPS of $1.33-1.43 is reaffirmed, with Q2 guided above our and consensus expectations. Expectations for volume recovery in some of the higher margin commercial segments remain limited, suggesting less upside potential to margin outlook. We fine tuned our EPS estimates higher for 2010, to $1.39 from $1.35, and 2011 to $1.71 from $1.68. Reiterate Market Perform.

**Q1 Results As Guided.** Revenue of $174mm was slightly ahead of our and the Street's expectations with "core" organic revenue up 18%, driven by strength in the federal business. EBITDA margin of 9.1% includes 30bps of CFO severance cost. EPS of $0.28 was in-line with guidance, and a penny below consensus estimates. Book/bill of 0.7x was seasonally flat yr/yr. Free cash flow remains strong at $16mm at sub-optimal DSO of 86 days.

**2010 Guidance Reaffirmed.** Revenue of $740-775mm assumes "core" organic growth of 11-16%. Guided EBITDA margin range of 9-10% is also unchanged. Excluding energy efficiency-based work, outlook for commercial segment remains flattish, limiting opportunity for meaningful upside to margin guidance, in our view. EPS guidance of $1.33-1.43 is unchanged and compares to our/consensus prior estimates of $1.35/$1.39.

**Analyst Day in New York City on May 11.** ICFI is hosting its first ever analyst day in Midtown, Manhattan, from 2:30-6:00 pm, and is expected to focus on emerging trends in the market place.

### NCI, Inc. (NCIT, Market Perform, $21.82)
### Guidance & Estimates Lowered On Stepped Up Investments And Mix

*Operating Margin Guided Lower Through 2011*
*Pricing Tougher*

**NCIT's Q1 EPS Met Expectation on Lower Tax Rate; Operating Margin and EPS Guidance Lowered Meaningfully.** Q1 ($115mm/$0.39) saw revenue below expectation, while EPS was a meet only due to a lower tax rate. Surprise was NCIT lowering operating margin outlook notably through at least September 2011 given both a rise in new business/infrastructure costs and an increased mix of pass-through heavy revenue. Tone suggested that federal contracting activity remains challenged therefore continuing the slow pace of award activity, and competitive pressure (i.e. pricing) is stiffening. Our 2010 EPS estimate went to $1.62 from$1.78 and 2011 to $1.78 from $2.01. Our valuation range dropped to $23-25 (13-14x CY11 EPS) from $30-33 (17-19x CY10 EPS). Risks include the uneven timing of government funding, still uncertain priorities for the Obama Administration, budget funding pressure from continued efforts in Iraq and Afghanistan, and a rapidly growing federal deficit given the economic downturn. In addition, there will be more uneven timing from an increased reliance on pass-through revenue. Also, though the founder has reduced his stake to about 20%, he still controls more than 80% of the voting rights. We are maintaining our Market Perform investment rating.

**Q1 Disappoints.** Revenue of $115mm was up 9% (6% organically) and was below expectation primarily on lower than expected pass-throughs. Operating margin was an as expected 7.7%. EPS of $0.39 was in-line with expectations, but benefitted by nearly $0.02 from a below guided tax rate.

**Guidance Lowered Notably.** 2010 revenue guidance was raised by about $15mm to $550-565mm, but reflects higher than previously assumed low-margin pass-through revenue. This, combined with acceleration of new business and infrastructure investments, led to a drop in operating margin guidance to 7.0% from 7.8-7.9%. This in turn led to EPS guidance being reduced to $1.64-1.72 from $1.74-1.82.

**SRA International (SRX, Market Perform, $21.35)**
**FQ3 Essentially In-Line**
**Little Change To The Story/Issues**
*Fine-Tuned Model Only*

**FQ3 Revenue of $411mm And Pro Forma EPS Of $0.29 Were Essentially In-Line With Our Expectations ($400mm/$0.30).** FQ3 also included several one-time items related to the struggling Era business, which is expected to continue generating operating losses for now. We fine-tuned our EPS estimates reflecting adjustment to non-cash, non-operating items. FY10 unchanged at $1.26, FY11 went to $1.40 from $1.37 and FY12 to $1.56 from $1.55. Our valuation range moved to $19-21 (13-14x CY11 EPS) from $17.50-19.50 to realign valuation with the government services peers. Risks include ongoing losses in the Era business, the vagaries of having the U.S. federal government as a client, increasing competition especially as pursued deals get larger, large re-compete exposure in FY10, acquisition assimilation, and potential share overhang from the founder. We reiterate our Market Perform rating based on valuation and lack of visible catalyst.

**DynCorp (DCP, Market Perform, $16.80)**
**LOGCAP IV-Iraq Opportunity Stays with KBR**
*No Impact Regarding Pending Acquisition*

The U.S. Army cancelled the LOGCAP IV competition for some of the legacy logistics work in Iraq preferring to extend the existing LOGCAP III agreement with incumbent KBR (KBR). The contract value had an estimated value of $570mm. DCP and Fluor (FLR) are the other competitors on the LOGCAP IV contract vehicle, and have not yet publicly expressed whether they will protest the Army's decision.

Bottom-line: The cancellation removes a potential positive revision to our FY11 and FY12 EPS estimates for DCP, although we had not assumed any LOGCAP IV Iraq work in our model. Notably, the definitive acquisition agreement for DCP by private equity firm Cerberus does not provide exit clauses with regard to contract activity, so we do not believe the proposed transaction is negatively affected by this announcement.

## RESEARCH COMMENTS – Consulting & Systems Integration

**Diamond (DTPI, Outperform, $8.62)**
**Better FY11 Guide; Estimates Raised**
**Upgraded to Outperform**
*Tone Remains Cautious Suggesting Upside Potential*

**FQ4 Beat, FY11 Guidance Well Above Street, Our Estimates Raised Notably; Rating Upgraded To Outperform From Market Perform.** FQ4 ($50mm/$0.11) was better on both the top- and bottom-line. Initial FY11 guidance assumes steady, but modest, improvement with revenue up 20-25% and EPS well above prior Street expectations. We raised our FY11 EPS estimate to $0.54 from $0.36 and FY11 to $0.64 from $0.48. Our Valuation range rose to $10-12, which is 16-20x our higher CY11 EPS of $0.61 up from $7-8 (21-24x prior CY10). Risks include sensitivity of revenue to economically sensitive short duration projects, a need to improve effective billing rates, and to ensure stability of the consulting workforce as business improves. Also, the tax rate remains very sensitive to the level of international profitability. We also note that DTPI raised its quarterly dividend rate today to $0.09 from $0.07, which moves the dividend yield to over 4%. In addition, DTPI has been repurchasing shares so far in the June quarter and intends to continue doing so. We raised our rating to Outperform from Market Perform, as we expect the estimate bias to remain up with any improvement in the economic outlook. Historically, DTPI has been a levered play on an economic recovery for small-cap investors.

**FQ4 Above Expectation.** Revenue of $50.3mm was up 40% yr/yr (all organic) and ahead of our and Street expectations. The strong revenue growth combined with high chargeability of 77% lifted pre-tax margin to 11.5% compared to our 9.7% expectation. This yielded EPS (excluding U.K. tax allowance reversal) of $0.11 compared to expectations for $0.09.

**FY11 Guidance Much Better, But Assumptions Still Muted, In Our View.** Headcount adds expected to rise about 15%, chargeability is expected to ease about 1%, and pricing to be modestly up. This drives revenue growth of 20-25% and EPS of $0.53-0.58. Given the short-term project nature of DTPI's revenue further economic improvement should lead to estimate upside. We note that with this earning report, DTPI has returned to providing annual guidance, which we take to be a sign of rising visibility.

**Sapient (SAPE, Market Perform, $9.46)**
**Q1 Better Than Expected**
**2010, 2011 Guidance Reaffirmed**
*2010 Adjusted Operating Margin Guide Assumes Meaningful Improvement in H2*

**Q1 Results Ahead of Estimates; 2010 & 2011 Guidance Reaffirmed.** SAPE reported Q1 revenue of $183mm, up 24% yr/yr cc, which was slightly ahead of our and consensus expectations and guidance. EPS of $0.05 was a penny better than our/Street estimate driven by higher revenue and operating margin. Management tone was incrementally more positive on client spend environment, including pricing, driven by recent signings in both SapientNitro and Global Markets units. 2010 guidance of 20% plus revenue growth and adjusted operating margin ("AOM") target of 11-12% was reaffirmed, as well as 2011 AOM target of 13-16%. Our 2010 EPS estimate of $0.31 is unchanged and our 2011 estimate was raised a penny to $0.48. We reiterate our Market Perform with a positive bias.

**Q1 Revenue, EPS Better Than Expectations.** Revenue of $183mm was up 24% yr/yr and up 1% q/q cc as SapientNitro business (63% of revenue) was flat q/q after a budget flush in Q4. Global Markets was up 24% yr/yr and 2% q/q cc. Guidance was $177-181mm; our and the Street's estimate was $180mm. AOM of 8.1% was up 20bps yr/yr and 110bps above guidance. Average pricing is now flat after modest improvement in new engagements during the quarter. EPS of $0.05 was a penny better than our and consensus expectation.

**2010-11 Guidance Targets Reaffirmed.** SAPE was incrementally more positive on outlook for interactive work based on improving demand from existing clients, recent wins and a more active sales pipeline. 2010 revenue growth of 20% plus reaffirmed, and AOM guidance of 10-12% assumes notable improvement in H2 from Q2 base of 9.5% plus, driven by higher utilization and price realization. 2011 AOM guidance of 13-16% also reaffirmed.

**CIBER, Inc. (CBR, $3.31)**
**Dropped Research Coverage**
*Final Rating Market Perform*

**Dropped Research Coverage Of CBR Shares.** We believe that CBR remains weakly positioned to grow in the IT services space long term. This primarily reflects the lack of a meaningful offshore presence. Also, the European sector, which has been a meaningful contributor to growth in recent years, may struggle given the increasing turmoil in the wake of the expanding Greek debt crisis. We note that CBR has regularly missed/lowered guidance in recent periods. While CEO change does offer some hope for positive change, it also increases uncertainty for the outlook. Our final rating was Market Perform (unchanged). We fine-tuned our valuation range to $3.00-3.25, which is 15-16x our (pre-CEO severance) 2010 EPS expectation, from $2.75-3.25. Risks to the investment thesis include sensitivity to the economically driven IT spending slowdown, general pricing pressure, and weakness in Europe that had previously been a major growth driver.

**Q1 Was Essentially In Line.** Revenue of $262mm was up 2% yr/yr and 0.8% qtr/qtr. Operating margin remained modest at just 2.7%. Tax rate was higher than expected at 37.7% given the lack of a federal R&D tax credit extension. EPS of $0.05 was in line with Street expectations and $0.01 better than our estimate.

**2010 EPS Guidance Lowered Even Before CEO Severance Impact.** Revenue growth of plus/minus 1% remains unchanged. EPS guidance lowered (again) to $0.22-0.26 from $0.25-0.29. This reflects both management transition costs--but not the severance costs for the CEO, which we assume will be meaningful, as well as a higher assumption for ongoing costs.

**Maintained Below Consensus/Guidance EPS Estimate For 2010.** We look for EPS of $0.20 this year and $0.25 next year. Our 2010 estimate does not include the yet-to-be-determined CEO severance impact.

## RESEARCH COMMENTS – Offshore

**Cognizant (CTSH, Outperform, $47.95)**
**Q1 Better; Guidance & Estimates Raised Notably**
*Management Now Looking For 25%+ Top-line Growth This Year*

**CTSH Had A Strong Q1 And Raised CY10 Guidance Notably; Estimates Raised And Our Outperform Rating Reiterated.** CTSH reported better than expected Q1 ($960mm revenue/$0.49 EPS) driven by top-line upside as FX diminished (relative to guidance) some of the EPS upside. CY10 guidance was subsequently raised and now assumes 25% plus CY10 revenue growth up from prior guidance of 20% plus. Tone remains cautiously optimistic, although some of the caveats are being removed. Still setting tempered H2 expectations, which we believe may prove conservative. We raised our CY10 EPS to $2.13 from $2.05 and CY11 to $2.27 from $2.18. Valuation range moved to $58-62 (26-27x CY11 EPS) from $50-55 (24-27x CY10 EPS). Risks to our valuation range include a large exposure to the financial services vertical, risk of a pullback in a still recovering global economy, potential new US visa limitations, and increased competition from global service providers.

**Q1 Better Than Expected.** Revenue of $960mm was up 29% y/y and 6.3% q/q and well above guidance ($935mm) and Street expectations ($939mm). Adjusted operating margin of 20.5% was helped by above expectation growth in applications development work. Operating cash flow hedging also helped ease the INR/USD headwind. Cash flow was modest given normal seasonality and a four day uptick in DSO.

**Guidance Raised, More So on Top-line.** CY10 revenue guidance is now "at least" 25% up from "at least" 20% a quarter ago. Wrapping up of some large M&A related work, concern that some of the uptick in discretionary spending may reflect a temporary catch up and a general cautiousness keeps the company more cautious for H2. They were clear that no uptick in economic activity was assumed in the current H2 outlook. Otherwise, CTSH was incrementally more positive on the pace of discretionary spending, which would signal a sustained recovery in IT spending. Revenue growth continues to be broad based by vertical, geography and service offering with recent initiatives running well above the corporate average.

**ExlService Holdings (EXLS, Market Perform, $16.03)**
**Surprise 2011 Guidance Better Than Expected**
**Raised Estimates**
*Q1 Solid, 2010 Guided Higher*
*20+% Organic Growth Guided in 2011*

**Strong Q1 Results and Tuck-in Acquisition Drive 2010 Guidance Higher, 2011 Organic Growth Above Expectations.** EXLS reported Q1 revenue of $54mm, up ~29% yr/yr organic, which was better than expected. EPS of $0.19 was well above consensus of $0.13 and our $0.11 estimate. 2010 revenue guidance was raised to account for small acquisition and improved visibility, with adjusted operating margin now expected near top of prior 12-14% range. EXLS unexpectedly set 2011 growth target of ~30% including organic expectations of 20% or better. We raised our 2010 EPS estimate to $0.69 from $0.56 and 2011 to $0.81 from $0.68. Our valuation range now $18-19 from $17-18. Risks to our valuation range include potential economic/credit driven declines in activity levels, notable client concentration, slow ramp of new facilities, uneven pace of FX gains/losses, integration risk of potential acquisitions, and potential share overhang given 37% ownership by a pre-IPO investor. We reiterate our Market Perform rating with a positive bias.

**Solid Q1 Results.** Revenue of $54mm was up 33% yr/yr and flat q/q (ex Q4 Aviva payment), and includes one month of recent AmEx captive acquisition. Our and the Street's estimate were $53mm/$52.1 mm. Outsourcing revenue was up 25% yr/yr, while more discretionary Transformation services revenue was up 70% yr/yr. Gross margin and continued cost containment drove operating margin to 11.9% and EPS to $0.19, above our/Street estimates of $0.11/$0.13. Seat utilization of 1.27x was flat q/q.

**2010 Guidance Revision Better Than Expected.** Revenue guided to $235-240mm from $225-230mm and assumes ~$6-7mm from recently acquired PDMA, and greater visibility on demand in H2. Our/Street estimate was $228mm. Adjusted operating margin guidance of 12-14% is reaffirmed and biased toward the top end of range. Guidance for FX hedge gains raised given rupee appreciation.

**Positive 2011 Guidance Issued Unexpectedly.** EXLS guided 2011 organic growth to 20% plus based largely on current book of business, and expects to add an additional ten points of growth through smaller acquisitions. Our prior estimate was 16% organic; Street 15%. The company is optimistic it can improve upon current adjusted EBITDA (adj op margin less depreciation) levels.

**Tier I Remain Cautious on European Growth**

Dow Jones queried leading offshore IT/BPO providers about the possible impact on business in Europe from the Greek debt crisis. Europe represents 20-30% of revenue for the Tier I providers. #2 Infosys (INFY) CFO indicated it "is a concern and we are watching it closely." #3 Wipro (WIT) indicated "it is yet to see its European clients start spending on non-essential technology requirements, as customers continue to conserve cash and optimize costs." Largest provider Tata Consultancy (TCS) did not respond to the email request, but had offered cautious commentary on their most recent earnings call.

*Bottom-line:* While we do not think the article offers any new news, it confirms that European IT/BPO decision making continues to lag that of the U.S., which is currently the primary driver of the revenue growth recovery for the offshore IT/BPO providers.

## RESEARCH COMMENTS – Outsourcing

**CGI Group (GIB, Outperform)**
**Announces Acquisition of Stanley (SXE)**
*Increases Presence Within U.S. Federal Market*

**Friday Morning GIB Announced It Has Entered Into A Definitive Agreement To Acquire U.S. Federal Services Provider Stanley (SXE) For $1.07bn (CY11: 16.7x EPS, 9.7x EBITDA).** SXE is one of the most well regarded and fastest growing public companies in the U.S. Federal space. A deal of this nature fits the strategic priorities of GIB's build and buy growth strategy focusing on the U.S. and Western Europe as well as its financial hurdle of being GAAP accretive within the first twelve months (which we do not see being a stretch). We believe the patience management has demonstrated with M&A (last acquisition being AMS in 2004) and the addition of a quality asset in SXE should ease investors' concerns over the company's build and buy strategy.

**Terms of the Deal / Funding.** GIB has agreed to pay $1.07bn in cash or $37.50 per SXE share. The deal is expected to close by fall 2010. Break-up fee of $28mm is payable to GIB under customary circumstances. GIB expects to use cash on hand and draw upon its $1.5bn credit facility (Libor +60bps) to fund the acquisition. Post the acquisition the company expects to have a net debt to capitalization ratio between 20-30%, and net debt to EBITDA of 1.1-1.4x which is still within a comfortable range given its strong cash flow. The company will have $600mm of remaining liquidity after the deal.

**Valuation.** Based on Wells Fargo Securities, LLC estimates for SXE the transaction is valued at 16.7x CY11 EPS and 9.7x EV/EBITDA. Based on Thursday's close the P/E and EV/EBITDA ranges are 11-15x and 5.5-7.8x, respectively. SXE's higher growth and margins compared to the group justify the premium, in our view.

**What Stanley Gives CGI.** A much larger presence within the U.S. Federal space as combined revenue post the deal is expected to be ~$1.2bn up from $350mm in CY09. An entrance into the Defense and Intelligence side of the Federal market (pre deal Defense & Intel was 1% of Federal rev; Post deal expected to be 55%). Areas of strength for SXE include systems engineering, Business Process Outsourcing, Biometrics/Cyber security, among others. Post the deal overall revenue from the U.S. is expected to be ~46% up from 33% today.

**TeleTech (TTEC, Outperform, $15.17)**
**Q1 Below Expectations--Lowered Estimates**
*Signings Acceleration Expected*

**Q1 Results Were Below Expectations As Volumes Continue To Be Weak And New Signings Delayed.** 2010 top-line and operating margin guidance were lowered due to the above reasons. The pace of deals entering the pipeline continues to accelerate and management expects a number of sizeable deals to be signed in the next couple of months as the rate in which decisions are being made is improving. Balance sheet remains healthy with growing cash balance and almost zero debt while cash flow strength continues. As volumes return, earnings growth should accelerate due to operating leverage as a result of access capacity. We lowered our 2010 revenue and EPS estimates to $1.10B and $1.03 from $1.16B and $1.21, respectively. Our 2011 estimates are now $1.12B and $1.18 from $1.22B and $1.36. Our valuation range is now $18-19 (15-16x our 2011 earnings estimate). Risks to our valuation range include lower call volumes and a delay in new deal signings due to the economy.

**Q1 Results Disappoint.** Revenue of $272mm compared to our and the Street estimates of $270mm and $272mm, respectively. Pro forma EPS of $0.22 compared to our and the Street's estimates of $0.25 and $0.26. Pro forma results exclude $1.5mm of restructuring and asset impairments. Pro forma operating margin of 7.7% was below our estimate of 8.7%. New signings of $55mm was on the lighter side but expected to pick up throughout the year. Cash at the end of Q1 was $134mm compared with $109mm in Q4 2009. Debt balance was $7mm. FCF of $45mm compared to $46mm in the year-ago period. The company repurchased 1.1mm shares for $19.6mm. At the end of March there was approximately $31mm authorized for future repurchases

**2010 Guidance Lowered.** Revenue of $1.10B compared to our and the Street's estimates of $1.16B and $1.15B. The company continues to experience volume weakness in particular within Europe and the technology vertical. Pro forma operating margin within the range of 8-9% compared to our estimate of 9.6%. The decrease in the margin outlook is a result of lower utilization due to volume weakness. We estimate 2010 EPS using the above revenue guidance and the midpoint of the operating margin guidance to be approximately $1.03. This compares to our former and the Street's EPS estimates of $1.21 and $1.22.

**Sykes Enterprises (SYKE, Market Perform, $18.99)**
**First Look -- Q1 Results Mixed**
**2010 Guidance Lowered**
*Q2 Guidance Implies Large 2H Ramp*

**The company posted revenue above expectations but Adjusted EPS fell short by $0.05.** Earnings were $0.02 higher than expectations using the company's guided tax rate. 2010 revenue guidance was lowered by $10mm and adjusted earnings by $0.05. 2011 EPS could be in the $2.00 range as management believes the 2H 2010 earnings run rate should be maintained going forward. The possible accretion suggested in the above assumption makes the stock more compelling after Tuesday's (3/4) sell off, in our view. 2010 guidance was reduced as a result of lower than expected ICT sales. Q2 guidance was well below expectations setting up a much steeper ramp than previously anticipated. Bulls will continue to argue that the long-term synergy forecast is conservative as the company again increased its guidance to $23-25mm from approximately $23mm discussed on the last call. SYKE's core results continue to be affected by two client terminations and softer volumes within EMEA and the technology vertical. The company continues to win new programs with new and existing clients within the Financial Services and Communications verticals. Our 2010 revenue and EPS estimates are $1.25bn/$1.46 from $1.25bn/$1.50. Our new 2011 estimates are $1.37bn/$1.90 from $1.37bn and $1.80. We lowered our valuation range to $23-25 (12-13x our 2011 EPS estimate) from $26-27. Risks include integration risk, a challenging economy with particular concerns for the technology vertical and European exposure, as well as a difficult business to operate due to high attrition, and wage inflation during better economic conditions.

**Q1 Results Mixed.** Revenue of $275mm (down 3.2% organic constant currency y/y) was above our and the Street's estimates of $270/268mm. Adjusted EPS of $0.18 was below our and the Street's estimate of $0.23. Using the company's guided tax rate of 25% Adjusted EPS would have been $0.25. Adjusted tax rate of 41% was higher than guidance due to a shift in the geographic mix of earnings to higher tax rate jurisdictions.

**2010 Guidance Lowered - Q2 Guidance Implies Large 2H Ramp.** 2010 revenue guidance of $1,230-1,245mm was lowered $10mm and compared to our and the Street's estimate of $1,250mm. Adjusted EPS of $1.33-1.50 was lowered $0.05 and compared to our and the Street's estimate of $1.50. Q2 revenue guidance of $305-310mm compared to our and the Street's estimates of $313/317mm. Adjusted EPS of $0.20-0.22 compared to our and the Street's estimates of $0.37/0.32. Q2 guidance implies a much steeper 2H ramp than current forecasts. Using the mid point of the Adjusted EPS guidance implies a quarterly run rate of $0.47 in 2H and $0.50 to hit the high-end of guidance (current Street estimate).

### Hewitt Associates (HEW, Market Perform, $38.07)

*Solid Quarter, Guidance Maintained*

**FQ2 Results.** Net revenue of $760.5mm compared to our and the Street's estimate of $752mm/$756mm. Net revenue was up 2% y/y (down 3% organic in cc excluding third party revenue). Pro forma EPS was $0.73 versus our and the Street's estimate of $0.69/$0.68.

**Segment Results.** Benefits Outsourcing net revenue of $360mm, flat y/y cc compared to our estimate of $385mm. HR BPO net revenue of $109.5mm, down 11% versus our estimate of $113mm. Consulting net revenue of $262.3mm up 1% y/y versus or estimate of $263.0mm.

**2010 Guidance Maintained.** Revenue growth at low to mid single digits; Our/Street's estimates were $3.05/$3.06bn. Pro forma EPS $2.85-2.95, Our & Street's estimates were $2.90/$2.91

## M&A / CAPITAL MARKETS ACTIVITY

- **IBM** (IBM) acquired privately-held cloud integration software provider Cast Iron Systems for an undisclosed amount.

- **Lionbridge** (LIOX) did a S-3 filing for a $100mm "mixed" shelf registration which is expected to be used for working capital, possible acquisitions of related businesses and other general corporate purposes.

- **Unisys** (UIS, Market Perform, $24.29) completed its previously announced agreement to sell its health information management (HIM) business to Molina Healthcare for $135mm in cash. The business represented about $110mm of 2009 revenue.

- Standard & Poor's upgraded its outlook on **Wipro** (WIT, Market Perform, $20.43) to positive from stable citing "Wipro's resilience to the global economic crisis and the company's ability to improve its operating performance despite the downturn." It also affirmed its 'BBB' long-term corporate credit rating on WIT. Additionally, the ratings service raised its long-term corporate credit rating on **Infosys** (INFY, Market Perform, $56.84) to 'BBB+' from 'BBB', citing "expectations of the company's robust operating performance, which we believe will continue to result in strong free operating cash flows." The outlook on INFY is stable. Standard & Poor's indicated they expect "the Indian IT service industry to deliver a robust operating performance."

## OFFSHORE – Other News

*(as of Thursday's close)*

| 1 Week Price Change | | YTD Price Change | |
|---|---|---|---|
| PTI | 4% | PTI | 21% |
| EXLS | (0%) | CTSH | 8% |
| SYNT | (4%) | G | 7% |
| SENSEX | (4%) | SAY | 7% |
| CTSH | (5%) | VRTU | 4% |
| S&P500 | (5%) | INFY | 3% |
| Group Average | (5%) | S&P500 | 1% |
| INFY | (5%) | Group Average | (1%) |
| G | (6%) | SENSEX | (4%) |
| SAY | (7%) | WIT | (8%) |
| VRTU | (8%) | SYNT | (9%) |
| WIT | (9%) | EXLS | (12%) |
| WNS | (10%) | WNS | (27%) |

Source: FactSet

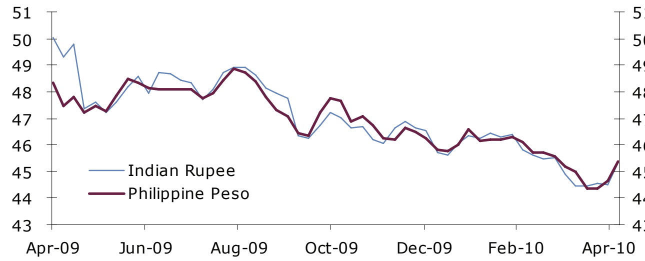
### Offshore: Local Prices (4/30/10-5/6/10)

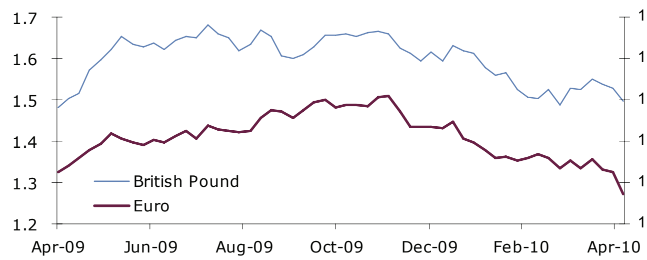
| Local Shares | Period | YTD | Indices | Period | YTD |
|---|---|---|---|---|---|
| PATNI-BOM | 5% | 16% | BSE IT | (4%) | (1%) |
| HCL-BOM | 0% | 4% | SENSEX | (4%) | (4%) |
| TCS-BOM | (2%) | (1%) | | | |
| SATYAM-BOM | (3%) | (12%) | | | |
| INFOSYS-BOM | (3%) | 0% | | | |
| WIPRO-BOM | (7%) | (8%) | | | |

Source: Bombay Stock Exchange Limited, Yahoo! Finance

### Foreign Exchange Rate Watch

| *(as of Thursday's close)* | Indian Rupee | Philippine Peso |
|---|---|---|
| Close (per 1 US dollar) | 44.52 | 44.64 |
| Full-year – 2008 | depreciated 23.6% | depreciated 15.2% |
| Full-year – 2009 | appreciated 4.5% | appreciated 2.8% |
| Over the past week | depreciated 1.8% | depreciated 1.7% |
| Quarter-to-date | depreciated 0.9% | depreciated 0.4% |
| Year-to-date - 2010 | appreciated 2.6% | appreciated 1.8% |




Source: FactSet

- **HCL Technologies** signed a five-year, $500mm agreement with MSD (Merck) which extends a previous relationship. HCL will provide services including software-led IT solutions, remote infrastructure management, engineering and business and knowledge process services. As a result of the agreement, HCL will expand its team in North Carolina, adding as many as 100 jobs (current headcount is 90).

- **HCL Technologies** named Rahul Singh President, Business Services and Corporate VP HCL Technologies. He previously served as CEO and MD of TCS eServe International.

- **Mahindra Satyam** (SAY) received a contract form BASF IT Services to provide managed services for the company's installed base of SAP, messaging and groupware as well as user administration. The deal includes a three-year base with two one-year options. Financial terms were not disclosed.

- According to an article in *Computerworld* a group of Senate Democrats, headed by Sen. Charles Schumer (D-NY), has proposed a framework for federal immigration reform which includes a provision providing automatic permanent residency to any foreign student earning an advanced degree in science, technology, engineering, or mathematics at a U.S. college or university. The graduate must have a job offer to be eligible. It is not clear how this would effect the 20,000 H-1B visas set aside annually for advanced degree graduates of U.S. universities. The outline also includes limiting H-1B visa use in individual companies.

## GOVERNMENT – Other News

*(as of Thursday's close)*

| 1 Week Price Change | |
|---|---|
| CACI | (1%) |
| SAI | (1%) |
| DCP | (1%) |
| MMS | (2%) |
| MANT | (3%) |
| SRX | (4%) |
| S&P500 | (5%) |
| Group Average | (5%) |
| SXE | (8%) |
| NCIT | (23%) |

| YTD Price Change | |
|---|---|
| MMS | 22% |
| DCP | 19% |
| SRX | 15% |
| SXE | 6% |
| Group Average | 2% |
| S&P500 | 1% |
| CACI | (3%) |
| SAI | (9%) |
| MANT | (10%) |
| NCIT | (21%) |

Source: FactSet

## Contract Announcements

| Company | Client | Details | Value ($MM) |
|---|---|---|---|
| ACS | DHCS | prime, 10-year Medicaid contract | 1.6B |
| Alion | Air Force | research, technical analyses, and testing for electronic warfare | 13.5 |
| Booz Allen | Navy | modification to provide for additional technical and engineering services | 23.5 |
| Booz Allen | Air Force | computer network defense solutions | 24.3 |
| Booz Allen | Air Force | information assurance network operations cyber security solutions | 14.5 |
| Booz Allen | Air Force | advanced technology, analysis, and layered defense | 8.9 |
| CACI | Army | 3-year cost-plus-fixed-fee | 12.7 |
| CACI | Army | cost-plus-fixed-fee, estimated completion August 28, 2009 | 12.7 |
| CTG | THSA | statewide health information exchange | NA |
| GIB | DHCS | 10-year Medicaid contract (on ACS team) | 168 |
| Kratos | NSWCDD | 1B, 4O, range support services | 49.9 |
| Kratos | Homeland Security | security system deployment and integration | 4.4 |
| ManTech | Navy | option extension | NA |
| MPRI | Army | T&M, est. completion Oct. 30, 2010 | 53 |
| MPRI | Army | 1-year cost-plus-fixed-fee | 32.2 |
| SAIC | Air Force | 90-day extension for non-personal advisory and assistance services | NA |
| Booz Allen<br>CACI<br>SRA Int'l | USSOCOM | 3B, 2O MA-IDIQ ($2,500 min.) | TCV: $1.5B |

DHSC = CA Department of Health Care Services
NSWCDD = Naval Surface Warfare Center, Dahlgren Division
THSA = Texas Health Services Authority
USSOCOM = US Special Operations Command
Note: ACS is a Xerox company
B=base year; O=optional year, MA=multiple award, TCV=total contract value, IDIQ=indefinite delivery, indefinite quantity
Source: Company information or government disclosures

- **ManTech** (MANT, Outperform, $43.78) has leased 63,000 square feet near the Aberdeen Proving Ground in MD, where it plans to relocate its subsidiary, Sensor Technologies, from NJ before the military base closure and realignment (BRAC) September 2011 deadline. MANT reportedly plans to hire/relocate up to 300 employees for the new facility, but said it could double Sensor's headcount if it exercises its option to lease the entire 125,000 square feet building.

## OUTSOURCING – Other News

*(as of Thursday's close)*

| 1 Week Price Change | |
|---|---|
| GIB | (2%) |
| IBM | (4%) |
| CSC | (4%) |
| TTEC | (4%) |
| ADP | (5%) |
| S&P500 | (5%) |
| IRM | (5%) |
| ACN | (6%) |
| CVG | (6%) |
| Group Average | (6%) |
| UIS | (11%) |
| SYKE | (15%) |

| YTD Price Change | |
|---|---|
| CVG | 11% |
| GIB | 6% |
| IRM | 5% |
| S&P500 | 1% |
| ACN | (1%) |
| ADP | (3%) |
| IBM | (5%) |
| Group Average | (8%) |
| CSC | (13%) |
| TTEC | (21%) |
| SYKE | (24%) |
| UIS | (36%) |

Source: FactSet

- **Capgemini** reported Q1 2010 revenue of €2,052mm ($2,592mm) almost flat sequentially and down 6.9% yr/yr (down 7.8% like-for-like). Compared with Q1 2009 North America saw growth mainly due to the recovery in IT investment in the financial services sector while Europe continued to lag that of the U.S. Bookings of €2,073mm ($2,616mm) were in line with forecasts. Consulting services, outsourcing services and local professional services businesses book-to-bill ratio was 1.06x and 1.30x in North America. Headcount increased 1% during the first quarter to 91,792 and the company has started hiring again. Capgemini maintained guidance provided in February of FY revenues declining 2-4%, with an operating margin rate of 6-6.5%. According to the company's CEO, Paul Hermelin "The global economic crisis impacted our industry late on, but signs of a recovery in corporate investment are multiplying."

- **Logica** reported Q1 2010 revenue of £939mm ($1,380mm), down 2% yr/yr versus an average 4% decline in the previous three quarters, benefiting from strong order bookings in 2009. The company said its saw continued strong growth in outsourcing services revenue, up 11% and an 8% decline in consulting and professional services which compares to an average 11% decline over the previous three quarters. Logica, which forecasts flat revenues for the year, said the U.K. and France were performing better than the Benelux region and Sweden. Orders of £1,093mm ($1,606mm) were down 7% yr/yr, resulting in a book/bill of 1.16x. Headcount increased to 38,689 at the end of March versus 38,780 at the end of December 2009. Total offshore and nearshore headcount of 5,200 was up 100 from the end of December. The company indicated they expect to grow nearshore and offshore headcount by around 10% in Q2.

- **Ness Technologies** (NSTC) joint venture with global defense electronics company Elbit Systems (ESLT), NessBit, won a four-year, $25mm contract from the Israeli Ministry of Defense to supply an information management system for the Israeli Air Force. Each company will receive $12.5mm.

- Highlights from outsourcing advisor Everest's quarterly report on global outsourcing and offshoring activity (Market Vista: Q1 2010) include:

North America recorded its best quarter of activity in the outsourcing market since Q4 2008. Q1 2010 transaction volumes valued at $3.9bn in annual contract value (ACV), maintained an even pace for the third consecutive quarter. Transaction activity increased 18% and ACV was up 36% sequentially. Globally, ACV remained similar to Q4 2009 and was up 31% yr/yr.

ITO continued to lead transaction activity with deal volume remaining steady and ACV rising 43%. BPO comprised 32% of deals signed, increased 30% in transaction volume, and saw a 7% drop in ACV.

The BFSI (banking, financial services, insurance) and MDR (manufacturing, distribution, retail) verticals contributed about 37% of deal signings. MDR contract signings were up 33%. The North American BFSI sector increased 54% in transaction volumes with the majority of deals signed in the banking sector.

In Europe, transaction activity increased slightly in volume, led by 33% growth in transaction volumes in the U.K.

According to Eric Simonson, managing principal of Research, Everest "while the outsourcing market's activity numbers look good, economic recovery remains slow and steady."

## GARTNER'S WORLDWIDE IT SERVICES VENDORS BY REVENUE

| ($ in millions) | 2009 | | | 2008 | |
|---|---|---|---|---|---|
| | Revenue | Market Share | Y/Y Chg. | Revenue | Market Share |
| IBM | 55,000 | 7.2% | (6.6%) | 58,892 | 7.3% |
| HP | 34,585 | 4.5% | (10.4%) | 38,584 | 4.8% |
| Fujitsu | 23,342 | 3.1% | (0.4%) | 23,444 | 2.9% |
| Accenture | 20,939 | 2.7% | (11.8%) | 23,732 | 2.9% |
| CSC | 16,004 | 2.1% | (6.5%) | 17,112 | 2.1% |
| Others | 613,191 | 80.4% | (4.7%) | 643,681 | 80.0% |
| **Total Market** | **763,061** | **100.0%** | **(5.3%)** | **805,445** | **100.0%** |

Source: Gartner (May 2010)

## NOTEWORTHY

- **Computer Sciences** (CSC, Market Perform, $49.84) named Andy Williams President of the company's Northern Europe business operations. He will also be responsible for the company's Managed Services business across EMEA. Mr. Williams was previously President of Alcatel-Lucent's services business.

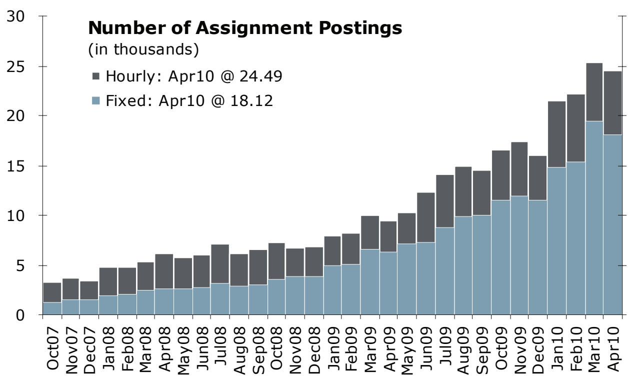
- **Computer Sciences** (CSC, Market Perform) appointed Siki Giunta VP of cloud computing and software services, replacing Brian Boruff who was promoted to VP of CSC's emerging technologies and strategic growth markets. Before joining CSC, she was President and CEO of Fortisphere; President and CEO of Managed Objects; Vice President of Strategic Business for Novell; and a SVP at Computer Associates.

- **SAIC, Inc.** (SAI, Market Perform, $17.57) EVP Arnold Punaro is retiring May 14. He is responsible for the company's government affairs, worldwide communications, real estate and support operations and general manager of their Washington operations. Mr. Punaro plans to start a strategic consulting business, complete a book on national security decision making and engage in other government-related projects.

- **Sapient**'s (SAPE, Market Perform) SapientNitro unit and aviation consulting firm SH&E, a subsidiary of **ICF International** (ICFI, Market Perform) formed a joint venture called IONOS ™, a multi-channel airport platform that delivers real-time travel and airport information personalized to the traveler throughout the entire trip.

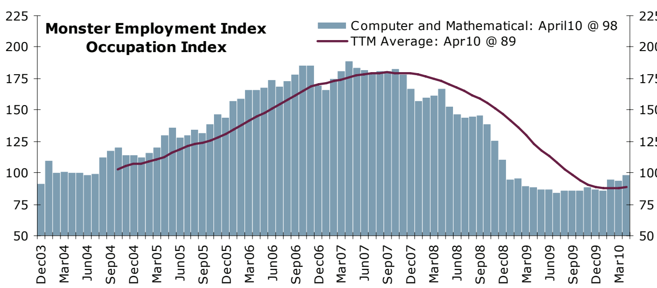
## MARKET STATISTICS

Jobs posted by rate classification on oDesk.com, a marketplace for IT services.



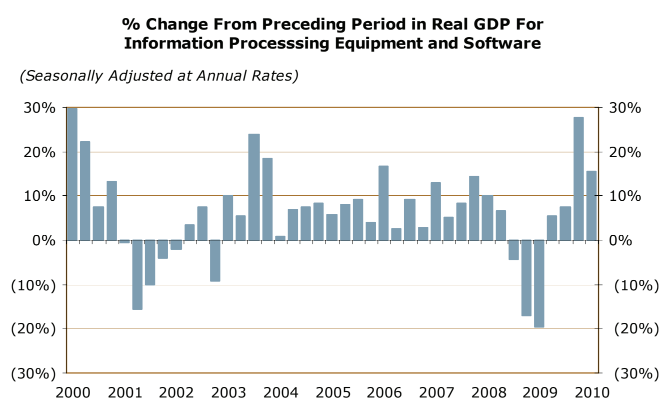

Source: oDesk; http://www.odesk.com/community/oconomy

Computer and Mathematical Occupation Index is sourced from the Monster Employment Index.




Source: Monster Worldwide, Inc.

Capital Spending For Information Processing Equipment And Software.




Source: U.S. Department of Commerce Bureau of Economic Analysis and Wells Fargo Securities, LLC

## UPCOMING INDUSTRY EVENTS

| Event | Date | Location/Info. |
|---|---|---|
| Alsbridge Outsourcing Leadership Summit | May 10-11 | Dallas, TX |
| ICF International Investor Day | May 11 | New York, NY |
| IBM Investor Briefing | May 12 | New York, NY |
| Harris Corporation Analyst Meeting | May 24-25 | Rochester, NY |
| Forrester's IT Forum 2010 | May 26-28 | Las Vegas NV |
| NASSCOM BPO Strategy Summit | June 9-10 | Bangalore, India |
| SRA Investor & Analyst Day | June 15 | New York, NY |
| KBR Analyst & Investor Day | June 23 | Houston, TX |
| Gartner Outsourcing & Vendor Management Summit | Sep. 14-16 | Orlando, FL |
| PSC Annual Conference | Oct. 3-5 | Farmington, PA |
| BPAP's International Outsourcing Summit | Oct. 26-27 | Manila, Philippines |
| Houlihan Lokey Aerospace, Defense, & Government Conference | Oct. 28 | Washington, D.C. |
| Wells Fargo Securities, LLC Tech & Services Conference | Nov. 16-17 | Boston, MA |
| IAOP 2011 Outsourcing World Summit | Feb 21-23 | Indian Wells, CA |

Source: Company information

## UPCOMING CALLS: 5/10-5/14

| Ticker | Report Date | Conf Call Date & Time (ET) | Dial-in Number | Pass Code |
|---|---|---|---|---|
| GTEC | 10-May | 10-May 5:00PM | 866-804-6928 | 22212139 |
| Vangent | 11-May | 11-May 5:00PM | 888-857-6931 | 5472546 |
| HCKT | 11-May | 11-May 5:00PM | 800-857-9601 | 1st Qtr, Ted Fernandez |
| TIER | 11-May | 11-May 5:00PM | 888-455-7818 | TierQ2 |
| TW | 12-May | 12-May 9:00AM | | |
| VRTU | 12-May | 12-May 5:00PM | 877-719-9795 | |
| APAC | 12-May | 13-May 11:00AM | 678-735-7977 | |
| VIT | 13-May | 13-May 7:30AM | 866-730-5763 | Vance |

Source: Company data, StreetEvents

## EARNINGS RESULTS: 5/3-5/7

| Ticker | 3/09 Actual | 3/10 Actual | % Change | Street Estimate | Above/ Below |
|---|---|---|---|---|---|
| SYKE | $0.36 | $0.18 | (50%) | $0.23 | ($0.05) |
| CTSH | $0.38 | $0.49 | 29% | $0.48 | $0.01 |
| NCI | $0.16 | $0.14 | (13%) | $0.15 | ($0.01) |
| ITIG | $0.02 | $0.05 | 150% | $0.08 | ($0.03) |
| WWWW | $0.18 | $0.13 | (28%) | $0.12 | $0.01 |
| FCN | $0.60 | $0.67 | 12% | $0.62 | $0.05 |
| LIOX | ($0.09) | $0.01 | NM | ($0.01) | $0.02 |
| EDGW | ($0.04) | ($0.05) | NM | ($0.06) | $0.01 |
| CBR | $0.07 | $0.05 | (29%) | $0.05 | $0.00 |
| NCIT | $0.34 | $0.39 | 15% | $0.39 | $0.00 |
| ELOY | ($0.03) | ($0.15) | NM | ($0.02) | ($0.13) |
| ABCO | $0.25 | $0.37 | 48% | $0.33 | $0.04 |
| TTEC | $0.26 | $0.22 | (15%) | $0.26 | ($0.04) |
| EXLS | $0.10 | $0.19 | 90% | $0.13 | $0.06 |
| ANLY | ($0.44) | ($0.20) | NM | NE | NM |
| HEW | $0.60 | $0.73 | 22% | $0.68 | $0.05 |
| ICFI | $0.38 | $0.28 | (26%) | $0.29 | ($0.01) |
| MMS | $0.68 | $0.81 | 19% | $0.71 | $0.10 |
| DTPI | $0.02 | $0.11 | NM | $0.10 | $0.01 |
| PRFT | $0.11 | $0.12 | 9% | $0.12 | $0.00 |
| IT | $0.21 | $0.24 | 14% | $0.19 | $0.05 |
| SRT | $0.04 | ($0.21) | NM | $0.02 | ($0.23) |
| SAPE | $0.03 | $0.05 | 67% | $0.04 | $0.01 |
| SRX | $0.25 | $0.29 | 16% | $0.31 | ($0.02) |
| III | $0.07 | $0.07 | 0% | $0.06 | $0.01 |

Source: Company data, Thomson Financial

**Wells Fargo Securities, LLC Equity Research**
**IT/BPO Services**
**Summary Valuation For Followed Universe**

*($ in millions, except EPS)*

| Analyst [1] | | Price 5/7/10 | Rating | Mkt. Cap. (Basic) | Enter. Value (Basic) | EPS FY10E | EPS FY11E | EPS CY10E | EPS CY11E | P/E CY10E | P/E CY11E | Ent. Value/ EBITDA CY10E | Ent. Value/ EBITDA CY11E | Ent. Value/ Revenue CY10E | Ent. Value/ Revenue CY11E | Est. LTGR | PE/ LTGR CY10E | Ticker |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | **Global Service Providers** | | | | | | | | | | | | | | | | | |
| EC/EB | Accenture | $40.38 | 2 | $28,670 | $24,555 | $2.65 | $2.98 | $2.72 | $3.05 | 15x | 13x | 8.3x | 7.7x | 1.1x | 1.0x | 12% | 1.2x | **ACN** |
| EB/EC | CGI Group, Inc. | 15.01 | 1 | 4,386 | 4,351 | 1.13 | 1.27 | 1.16 | 1.31 | 13 | 11 | 6.3 | 6.0 | 1.2 | 1.1 | 12 | 1.1 | **GIB.A** |
| EC/EB | Computer Sciences Corporation | 49.84 | 2 | 7,655 | 9,535 | 5.10 | 5.25 | 5.07 | NE | 10 | NM | 3.8 | NM | 0.6 | NM | 10 | 1.0 | **CSC** |
| EB | Unisys Corporation | 24.29 | 2 | 1,034 | 1,415 | 3.09 | 3.30 | 3.09 | 3.30 | 8 | 7 | NM | NM | 0.3 | 0.3 | 11 | 0.7 | **UIS** |
| | **Consulting & Systems Integration** | | | | | | | | | | | | | | | | | |
| EC | Diamond | 8.62 | 1 | 234 | 174 | 0.29 A | 0.54 | 0.50 | 0.61 | 17 | 14 | 5.4 | 4.6 | 0.8 | 0.7 | 17 | 1.0 | **DTPI** |
| EC | Sapient Corporation | 9.46 | 2 | 1,270 | 1,110 | 0.31 | 0.48 | 0.31 | 0.48 | 31 | 20 | 12.3 | 9.0 | 1.4 | 1.2 | 20 | 1.5 | **SAPE** |
| | **Offshore IT Service Providers** | | | | | | | | | | | | | | | | | |
| EC | Cognizant | 47.95 | 1 | 14,270 | 12,699 | 2.13 | 2.27 | 2.13 | 2.27 | 23 | 21 | 14.5 | 12.4 | 3.1 | 2.6 | 20 | 1.1 | **CTSH** |
| EC | Infosys Technologies Limited | 56.84 | 2 | 32,456 | 28,924 | 2.30 A | 2.50 | 2.43 | 2.74 | 23 | 21 | 15.8 | 13.5 | 5.3 | 4.6 | 15 | 1.6 | **INFY** |
| EC | Syntel, Inc. | 34.00 | 2 | 1,411 | 1,198 | 2.35 | 2.45 | 2.32 | 2.45 | 15 | 14 | 9.5 | 8.5 | 2.6 | 2.3 | 20 | 0.7 | **SYNT** |
| EC | Wipro Limited | 20.43 | 2 | 29,995 | 29,266 | 0.67 A | 0.74 | 0.73 | 0.79 | 28 | 26 | 20.7 | 18.9 | 4.5 | 4.0 | 18 | 1.6 | **WIT** |
| | **Offshore BPO Service Providers** | | | | | | | | | | | | | | | | | |
| EC | ExlService Holdings, Inc. | 16.03 | 2 | 466 | 365 | 0.69 | 0.81 | 0.69 | 0.81 | 23 | 20 | 10.9 | 8.7 | 1.5 | 1.3 | 20 | 1.2 | **EXLS** |
| EC | Genpact Limited | 15.41 | 2 | 3,358 | 3,077 | 0.70 | 0.83 | 0.70 | 0.83 | 22 | 19 | 13.8 | 11.7 | 2.4 | 2.1 | 20 | 1.1 | **G** |
| EC | WNS Holdings, Inc. | 11.02 | 2 | 477 | 588 | 0.02 A | 0.02 | (0.05) | 0.19 | NM | 58 | 11.6 | 9.5 | 1.6 | 1.4 | 20 | NM | **WNS** |
| | **Government Service Providers** | | | | | | | | | | | | | | | | | |
| EC | CACI International | 47.41 | 2 | 1,429 | 1,783 | 3.43 | 3.75 | 3.60 | 3.90 | 13 | 12 | 6.8 | 6.2 | 0.6 | 0.5 | 12 | 1.1 | **CACI** |
| EC | DynCorp International, Inc. | 16.80 | 2 | 946 | 1,431 | 1.39 | 1.75 | 1.60 | 1.82 | 11 | 9 | 5.9 | 5.4 | 0.4 | 0.4 | 10 | 1.1 | **DCP** |
| EC | ICF International, Inc. | 22.09 | 2 | 426 | 554 | 1.39 | 1.71 | 1.39 | 1.71 | 16 | 13 | 7.6 | 6.7 | 0.7 | 0.7 | 15 | 1.1 | **ICFI** |
| EC | ManTech International | 43.78 | 1 | 1,584 | 1,687 | 3.45 | 3.85 | 3.45 | 3.85 | 13 | 11 | 6.6 | 5.9 | 0.6 | 0.6 | 12 | 1.1 | **MANT** |
| EC | NCI, Inc. | 21.82 | 2 | 297 | 297 | 1.62 | 1.78 | 1.62 | 1.78 | 13 | 12 | 7.0 | 6.3 | 0.5 | 0.5 | 15 | 0.9 | **NCIT** |
| EC | SAIC, Inc. | 17.57 | 2 | 6,798 | 7,043 | 1.24 A | 1.31 | 1.31 | 1.43 | 13 | 12 | 7.1 | 6.6 | 0.6 | 0.6 | 10 | 1.3 | **SAI** |
| EC | SRA International | 21.35 | 2 | 1,213 | 1,172 | 1.26 | 1.40 | 1.28 | 1.49 | 17 | 14 | 7.4 | 6.3 | 0.7 | 0.6 | 10 | 1.7 | **SRX** |
| EC | Stanley, Inc. | 36.82 | 1 | 887 | 1,022 | 1.90 | 2.05 | 1.96 | 2.25 | 19 | 16 | 10.9 | 9.5 | 1.1 | 1.0 | 15 | 1.3 | **SXE** |
| | **Business Services** | | | | | | | | | | | | | | | | | |
| EB | Convergys Corporation | 11.90 | 1 | 1,472 | 1,580 | 1.05 | 1.23 | 1.05 | 1.23 | 11 | 10 | 6.1 | 5.4 | 0.7 | 0.7 | 10 | 1.1 | **CVG** |
| EB | Hewitt Associates, Inc. | 38.07 | 2 | 3,543 | 3,523 | 2.90 | 3.12 | 2.98 | NE | 13 | NM | NM | NM | 1.1 | NM | 12 | 1.1 | **HEW** |
| EB | Iron Mountain | 24.13 | 1 | 4,913 | 7,809 | 1.13 | 1.35 | 1.13 | 1.35 | 21 | 18 | 8.3 | 7.6 | 2.4 | 2.3 | 18 | 1.2 | **IRM** |
| EB | Sykes Enterprises, Inc. | 18.99 | 2 | 900 | 732 | 1.46 | 1.90 | 1.46 | 1.90 | 13 | 10 | 7.1 | 4.5 | 0.6 | 0.5 | 10 | 1.3 | **SYKE** |
| EB | TeleTech Holding | 15.17 | 1 | 933 | 799 | 1.03 | 1.18 | 1.03 | 1.18 | 15 | 13 | 5.5 | 5.1 | 0.7 | 0.7 | 15 | 1.0 | **TTEC** |

CGI Group (GIB) estimates and price are in Canadian Dollars; associated ticker is GIB.A
Note: WNS reported preliminary results (because of ongoing restatements in the auto claims business).
[1] EC - Ed Caso (443) 263-6524; EB - Eric Boyer (443) 263-6559
Rating Legend: 1-Outperform, 2-Market Perform, 3-Underperform

Source: Wells Fargo Securities, LLC estimates, company management, and FactSet

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**ACN:** Risks include an extended period of slow economic activity and therefore IT driven investment, delayed recovery of the outsourcing business, increased competition from both domestic and offshore service providers, and growing uncertainty of when and if operating margin will again turn up, although management is now indicating several signs of bottoming/recovery.
**CACI:** Risks include historic reliance on more "pass-through" related revenue growth which has a dampening impact on operating margin and generates more quarterly volatility to results, as well as relatively higher financial leverage.
**CBR:** Risks to the investment thesis include sensitivity to the economically driven IT spending slowdown, general pricing pressure, and weakness in Europe that had previously been a major growth driver.
**CSC:** The primary risks to our thesis are CSC's execution on its UK NHS project, and the impact of the economy on discretionary spending and longer-term deal signings. Other factors are a highly competitive ITO market, offshore cannibalization, and execution issues.
**CTSH:** Risks to our valuation range include a large exposure to the financial services vertical, risk of a pullback in a still recovering global economy, potential new US visa limitations, and increased competition from global service providers.
**CVG:** Risks to our valuation range include a decrease in demand for services during a period of slower economic growth, customer concentration, and foreign exchange.
**DCP:** Risks include a reliance on the timing of government funding and timing of project ramps, therefore a history/expectation of rather uneven revenue and earnings. Ramp up of LOGCAP IV task orders (and associated revenue recognition timing), increased uncertainty around CIVPOL (police training) related work, and a small chance of fallout from the self-reported possible FCPA violation.
**DTPI:** Risks include sensitivity of revenue to economically sensitive short duration projects, a need to improve effective billing rates, and to ensure stability of the consulting workforce as business improves. Also, the tax rate remains very sensitive to the level of international profitability.
**EXLS:** Risks to our valuation range include potential economic/credit driven declines in activity levels, notable client concentration, slow ramp of new facilities, uneven pace of FX gains/losses, integration risk of potential acquisitions, and potential share overhang given 37% ownership by a pre-IPO investor.
**G:** Risks include need to continue expansion/ penetration of the faster growing non-GE business, ability to attain qualified personnel at reasonable wage levels, price paid and assimilation of potential acquisitions.
**GIB:** Risks to our valuation range include a weak economy, revenue concentration with BCE, acquisition integration.
**HEW:** Risks to achieving this range include deteriorating market for discretionary HR consulting and project related services, HR BPO contract losses, and rising unemployment.
**ICFI:** Risks to our valuation include the uneven timing of government funding, prolonged weakness in demand from ICF's commercial and state/local markets, a rapidly growing federal deficit, and relatively higher financial leverage.
**INFY:** Risks to our valuation range being too conservative is that revenue growth from new sources meaningfully accelerates driving up the EPS estimate. Further improvement in operating margin from already high levels would also increase results.
**IRM:** Valuation risks include weak enterprise spending due to a soft economy, a prolonged period of high unemployment, digital storage cannibalizing core physical storage demand, and a high debt level.
**MANT:** Risks include exposure and uncertain timing of in-theatre support contracts (about 25-30% of revenue), acquisition assimilation, concentrated ownership with two classes of stock impacting voting power, and the vagaries of having the U.S. federal government as a client.
**NCIT:** Risks include the uneven timing of government funding, still uncertain priorities for the Obama Administration, budget funding pressure from continued efforts in Iraq and Afghanistan, and a rapidly growing federal deficit given the economic downturn. In addition, there will be more uneven timing from an increased reliance on pass-through revenue. Also, though the founder has reduced his stake to about 20%, he still controls more than 80% of the voting rights.
**SAI:** Risks include timing of federal outlays, delays or directional change related to the new Obama administration, including expected increase in oversight/audit, and uneven timing of higher margin product ("VACIS") sales.
**SAPE:** Risks to our model include sustained growth in "Interactive" solutions, and more so successfully improving pricing, utilization and SG&A leverage to meet guided improvement in adjusted operating margin. Historical track record has been mixed on sustaining margin improvement.
**SRX:** Risks include the vagaries of having the U.S. federal government as a client, increasing competition especially as pursued deals get larger, large re-compete exposure in FY10, acquisition assimilation, and potential share overhang from the founder.
**SXE:** Risks include the uneven timing of federal outlays especially during this period of Administration change uncertainty, as well as acquisition assimilation on potential deals that appear more likely. SXE faces a FY11 growover challenge from the PEO STRI contract.
**SYKE:** Risks include integration risk, a challenging economy with particular concerns for the technology vertical and European exposure, as well as a difficult business to operate due to high attrition, and wage inflation during better economic conditions.
**SYNT:** Risks include SYNT's need to consistently penetrate its top ten clients. Also, the Chairman's family controls about 70% of the shares, limiting share liquidity. Near-term concerns include the renegotiation of State Street BPO/KPO relationship and options for accretive deployment of significant cash balance.
**TTEC:** Risks to our valuation range include lower call volumes and a delay in new deal signings due to the economy.
**UIS:** Risks include limited financial guidance, company restructuring, pace of IT spending recovery, and maturing higher-margin legacy product sales and services.
**WIT:** Risks to the Valuation Range include uneven economic activity, confusing presentation of financials (Indian GAAP, IFRS with "convenience translation"), and growing protectionist measures in the U.S. Additionally, we believe any effort to increase float of the ADS could lead to a contraction in the premium over the local shares (historically 40-60%).
**WNS:** Risks to our valuation range include customer concentration, lumpy sales, uneven FX gains/losses, high employee turnover, and potential share overhang.

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**2=Market Perform**: The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD
**3=Underperform**: The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

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**As of: May 7, 2010**

| | |
|---|---|
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May 7, 2010

WELLS FARGO SECURITIES

# *Equity Research*

## Isis Pharmaceuticals, Inc.

**ISIS: Mipomersen Data By End Of June?**

**Outperform / V**

Sector: Biotechnology
Market Weight

- **Summary.** Yesterday (5/6), investors received an update on mipomersen from both the Isis Q1 call and Genzyme's analyst day. At the May 6, 2010, Genzyme analyst day, mipomersen was highlighted as one of three key late-stage pipeline products and we highlight portions of this presentation below. Mid-2010 should be a pivotal period in Isis' history as it completes three key studies for mipomersen. Cash and equivalents as of March 31, 2010, were $519 million.
- **Mipomersen, "A Transforming Product."** It was clear that Genzyme has no plans for returning the rights to mipomersen to Isis. To the contrary, Genzyme has created the new Personalized Genetic Health business unit, which will include cardiovascular products (*Cholestagel* and mipomersen). The unit is to be overseen by John Butler, SVP, who was instrumental in helping grow the renal franchise. Mr. Butler's prior experience as VP of *Renagel* Europe should be critical in a strong initial EU launch in late 2011/early 2012 as there are roughly 15,000+severe and 25,000 HeFH patients in Europe. Although *Cholestagel* is not a key product for Genzyme in Europe, marketing the product has provided invaluable experience in building EU KOL and lipidologist relationships and in negotiating drug pricing in the cholesterol market. Genzyme has met with the EMeA, reviewed Phase II and III data, engaged in the EMeA's formal Scientific Advice Process, and expects initial feedback during the summer. In the meantime, Phase III data from the 301012-CS12 study in high-risk hypercholesterolemia and MIPO3500108 study in severe hypercholesterolemia not on apheresis are due in late June/early July. These data would round out the MAA and NDA packages, which are to be submitted in H1 2011. The Phase I subcutaneous MIPO3200309 study evaluating 30mg daily, 70mg thrice weekly, and 200mg once weekly (for three weeks) are expected in early Q3. More-frequent dosing may provide for improved tolerability and ultimately fewer patients discontinuing therapy. These data would be used to help design the outcomes study required to support approval in HeFH (U.S.) and the larger polygenic populations (U.S. and EU). In addition, upon confirmation in a larger efficacy study, Genzyme plans on seeking inclusion of the 30mg and 70mg dose data in the approved labels. Finally, Mr. Butler noted that in the HeFH patients who experienced increases in ALT levels above 3x the upper limits of normal, that the median LCL-c reduction was 44%, higher than the 33% mean placebo-adjusted reduction in the ITT group. This apparent pharmacologic effect may help stem investor concerns over the transient ALT elevations.

### *Earnings Reported*

| EPS | 2009A | 2010E Curr. | 2010E Prior | 2011E Curr. | 2011E Prior |
|---|---|---|---|---|---|
| **Q1** (Mar.) | $1.57 | **($0.10) A** | **(0.10)** | NE | |
| **Q2** (June) | (0.03) | (0.12) | NC | NE | |
| **Q3** (Sep.) | (0.07) | **(0.09)** | **(0.08)** | NE | |
| **Q4** (Dec.) | (0.17) | (0.13) | NC | NE | |
| **FY** | $1.58 | ($0.43) | NC | ($0.01) | NC |
| **CY** | $1.58 | ($0.43) | | ($0.01) | |
| **FY P/E** | 5.9x | NM | | NM | |
| **Rev.(MM)** | $122 | $120 | | $158 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

*2009 quarterly EPS do not sum to the full-year total due to restatements.*

| | |
|---|---|
| Ticker | ISIS |
| Price (05/07/2010) | $9.36 |
| 52-Week Range: | $8-19 |
| Shares Outstanding: (MM) | 97.0 |
| Market Cap.: (MM) | $907.9 |
| S&P 500: | 1,128.15 |
| Avg. Daily Vol.: | 1,146,720 |
| Dividend/Yield: | $0.00/0.0% |
| LT Debt: (MM) | $162.5 |
| LT Debt/Total Cap.: | 0.4% |
| ROE: | 0.0% |
| 3-5 Yr. Est. Growth Rate: | 30.0% |
| CY 2010 Est. P/E-to-Growth: | NM |
| Last Reporting Date: | 05/06/2010 Before Open |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

**Valuation Range: $15.00 to $17.00**
We value Isis based on a sum-of-the-parts analysis using our 2013 revenue estimate of $247 million, capitalized 6-7x, and discounted at 20%; combined with an estimated YE:2010 cash position of $420 million and pipeline/IP estate value of $400-500 million to arrive at a 2010 value of $1.8-2.0 billion. With 116 million shares outstanding, we arrive at a valuation range of $15.00-17.00. Risks include failure of clinical trials and changes in mipomersen regulatory requirements.

**Investment Thesis:**
In our opinion, Isis offers the most risk-averse and diversified investment vehicle in the field of RNA-targeted drug discovery. Isis is composed of three value drivers: a therapeutics business composed of 22 compounds, broad ownership in satellite companies, and the broadest IP estate in the field.

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## Company Description:

Isis Pharmaceuticals, Inc., based in Carlsbad, California, is a biopharmaceutical company focused on developing novel drugs that target RNA, including antisense. Antisense is an eloquent technology that targets the underlying cause of the disease. At least 12 known antisense mechanisms can be induced once an antisense drug binds to its target RNA, representing what we believe is one of the most versatile and eloquent approaches to drug discovery and development.

To support this technology, Isis has built the industry's leading intellectual property position in the field of RNA drug discovery, composed of more than 1,500 issued patents either owned or exclusively licensed by Isis. Whether it's RNAi, single-stranded oligos, microRNA or RNA splicing, they are all mechanisms of antisense and companies can't operate in the field without working with Isis. Well over $1 billion has been invested through partnerships, grants or direct equity. Major partners include Genzyme, Abbott, BMS, J&J, Eli Lilly, Pfizer, Merck, GSK, Novartis and Teva. In addition, Isis has seeded and successfully developed a number of satellite companies including Alnylam, OncoGenex, Regulus, Antisense Therapeutics, Atlantic Healthcare, Excaliard, Altair, Achoagen, iCo Therapeutics, and Ibis, which was sold to Abbott Labs for over $200 mm. Isis successfully commercialized the world's first antisense drug and has 18 antisense products in development to treat metabolic, cardiovascular, and inflammatory diseases and cancer, making Isis the most risk-averse and diversified company in the field of RNA targeted drug discovery. The most advanced compound is mipomersen, novel lipid lowering agent targeting ApoB-100, which was the subject of the highest ranking collaborations in the industry with Genzyme. Mipomersen is in Phase III development and offers proof-of-concept for the metabolic franchise.

## Exhibit 1. Isis' Upcoming Milestones Chart

**Isis Pharmaceuticals Upcoming Milestone Schedule**

| Timing | | Event |
|---|---|---|
| 2010 | | Advance 3-5 new compounds into pre-INDA evaluation and 3-5 into development. |
| 2010 | | Phase I data from the ten arm ISIS 353512 (CRP) study and ISIS 388626 (SGLT2) in Type II diabetes. |
| 2010 | | Teva/OncoGenex to initiate two Phase III studies for OGX-011 in prostate cancer. |
| 2010 | | Final open-label extension study data of mipomersen in HoFH and HeFH patients (n=40). |
| 2010 | | Determine next clinical steps for ISIS 113715 (i.e., initiate 26+ week Phase II studies in combination with metformin). |
| 2010 | | Initiate one-year toxicology studies in animal models to support 26-week dosing studies for ISIS 113715 in Type 2 diabetics. |
| 2010 | | Report final results of Phase II mipomersen fat liver content study in HeFH and FHBL patients. |
| 2010 | | Initiate a safety and efficacy study for mipomersen (length undetermined at November 2009 but likely to be at least 26-28 to 52 weeks) in HeFH patients in order to support approval in Europe. |
| 2010 | | Phase I results for iCo-007. |
| 2010 | | Report results for additional Phase II and III mipomersen studies. |
| | Mid-2010 | 301012-CS12, high-risk hypercholesterolemia, n=158. |
| | Mid-2010 | MIPO3500108, severe hypercholesterolemia not on apheresis, n=58 (formerly the apheresis eligible study). |
| | Mid-2010 | 301012-CS10, liver fat content study, nine arms (four active, four placebo, 1 FHBL control), n=38. |
| | Mid-2010 | 301012-CS19, high-risk, statin intolerant, Phase II, n=30 (expected to help in the design of the outcomes study). |
| | H2 2010 | 301012-CS17, Phase II extension study of CS8 and CS9, n=52. |
| H1 2010 | | Eli Lilly is to conclude the Phase II LY2181308 relapsed/refractory AML study. |
| H2 2010 | | Eli Lilly to conclude the Phase II LY2181308 + docetaxel hormone refractory prostate cancer study. |
| H2 2010 | | Phase II studies for ISIS 353512 to determine the appropriate CRP disease(s) and ISIS 388626 in Type II diabetes. |
| Q3 2010 | | Data from Altair's Phase II(a) study evaluating AIR 645 in asthma. |
| H2 2010/2011 | | Initiate the mipomersen survival study to support approval in HoFH and severe hypercholesterolemia (potentially) and required for HeFH and polygenic cholesterol. |
| H2 2010/ 2011 | | Atlantic Healthcare (partner) to initiate Phase III alicaforsen trials. |
| 2011 | | Initiate a 26-week Phase II(b) study(ies) of ISIS 113715 in Type 2 diabetics, likely in combination with metformin or metformin and a sulfonylurea. |
| 2011 | | Teva/OncoGenex to initiate a Phase III study of OGX-011 in non-small cell lung cancer (n=700 patients). |
| Late H1 2011 | | Genzyme to file the mipomersen NDA for the treatment of HoFH and potentially severe hypercholesterolemia patients (apheresis eligible). |
| Late H1 2011 | | Genzyme to file the mipomersen MAA for the treatment of HoFH and severe hypercholesterolemia patients. |
| Q2 2011 | | Mipomersen Phase III extension study results for studies CS5 and CS7, n=145 patients. |
| Late 2011 | | The FDA's approval of mipomersen in HoFH and potentially severe hypercholesterolemia (apheresis eligible). |
| Late 2011/2012 | | Genzyme's launch of mipomersen for HoFH and potentially severe hypercholesterolemia in the United States. |
| H1 2012 | | The EC's approval of mipomersen in HoFH and severe hypercholesterolemia and subsequent country launches. |
| Late 2012/H1 2013 | | Submit the sNDA and sMAA to support approval of mipomersen in HeFH (United States) and polygenic hypercholesterolemia (United States and Europe). |
| 2013 | | The EC's approval of mipomersen in HeFH and the subsequent launches in Europe. |
| 2013 | | Conclusion of the mipomersen outcomes study necessary for approval of HeFH and polygenic in the United States and polygenic hypercholesterolemia in Europe (paced by number of patients and estimated Phase II event rates). |
| H2 2013 | | The FDA and EC's approval of mipomersen in HeFH hypercholesterolemia. |

Source: Company reports and Wells Fargo Securities, LLC estimates

## Exhibit 3. Isis' Clinical Pipeline Charts

| ISIS Pharmaceuticals Partnered/External Pipeline Summary | | |
|---|---|---|
| **Candidate** | **Indication** | **Stage And Summary** |
| **Vitravene** (Novartis) | CMV Retinitis | **Marketed -** In 1998, Isis received FDA approval for the world's first antisense product, *Vitravene*, for treating cytomegalovirus (CMV)-induced retinitis, spawning a new era in disease treatment. However, due to the success of HIV protease inhibitors in delaying AIDS onset, the treatment has not served as a good commercial demonstration for antisense technology. |
| **Mipomersen** (Genzyme) | Familial Hypercholesterolemia (High-risk HoFH and HeFH) | **Phase III (Registration Studies Ongoing) –** Mipomersen is a second-generation antisense inhibitor of apolipoprotein B-100 (ApoB-100), a protein essential for the synthesis and transport of low-density lipoprotein C (LDL-C) - or bad cholesterol - and is the subject of an approximately $2 billion global collaboration with Genzyme. ApoB-100 is a target which has been of great interest in the cardiovascular community. Familial hypercholesterolemia (FH) is a genetic disorder characterized by extremely high lipid levels: 3-5x normal in heterozygous (He) patients and 6-9x normal in homozygous (Ho) patients. This leads to premature atherosclerosis and heart attacks. FH is an indication that offers an accelerated path to market as an orphan indication [HoFH]. We expect United States commercialization to occur in HoFH in early 2011 and potentially in high-risk, "*apheresis-eligible patients*", as well. FDA's initial guidance requested an outcomes study in HeFH. The RADICHOL Phase III HoFH study produced a 22% placebo-adjusted reduction in LDL-C (median of ~ 400 mg/dL down to 300 mg/dL). |
| | Polygenic/"routine" High Cholesterol (add on to statin therapy in high risk patients or unable to tolerate statin therapy) | **Phase III (start in H2 2010+)** – In Phase II studies mipomersen has demonstrated an ability to decrease lipid levels in a manner similar to what would be seen with other lipid-lowering agents, such as statins. LDL-C reductions have ranged from 20-50% with corresponding VLDL and triglyceride reductions. Mipomersen is being developed initially as a subcutaneous injection, thus it is to be positioned as a combination agent to statins and as an alternative for those who are intolerant to statins. At its 2009 Analyst Day Genzyme announced that the EMeA has indicated LDL-C is an approvable endpoint for the HoFH and severe hypercholesterolemia ("apheresis-eligible") patients. An HeFH indication is expected to require up to two-year safety data but won't require overall survival data as the FDA has requested. Genzyme plans to support the global polygenic filings with outcomes data from a study likely to start by mid to late 2010 (or early 2011) and data available by 2012+. Commercialization in the polygenic population is expected in 2013+ on a global basis. |
| **Alicaforsen** (Atlantic Healthcare Ltd.) | Pouchitis, Ulcerative Colitis | **Phase II/III -** *Alicaforsen* is the last antisense compound with first-generation phosphorothioate backbone chemistry remaining in the pipeline. *Alicaforsen* targets ICAM-1, is administered locally as an enema for the treatment of ulcerative colitis (UC), and has successfully completed three Phase II trials in UC. *Alicaforsen* was also studied in Crohn's disease, but did not meet the primary endpoint in two Phase III trials. In 2007, Isis licensed this compound to Atlantic Healthcare Ltd. (UK-based) which assumed all costs and development activity. The initial indication is expected to be for Pouchitis and subsequently Ulcerative Colitis. The FDA has granted orphan drug designation for the pouchitis indication. |
| **OGX-011** (custirsen sodium; OncoGenex/ Teva) | Prostate cancer (potentially lung, renal, bladder, and ovarian cancers) | **Phase III** – In December 2001, Isis licensed OGX-011, a second-generation antisense compound that targets the clusterin mRNA, which encodes a secretory protein associated with cell survival and resistance to cancer therapeutics. By down-regulating clusterin, OGX-011 is thought to potentiate the effects of chemotherapy, hormone ablation therapy, and radiation therapy. At ASCO 2008 Phase II data demonstrated progression-free (PFS) and overall survival (OS) of 7.2 months and 14.7 months when combined with prednisone. On July 3, 2008, OncoGenex amended the agreement with Isis and Isis no longer has to fund 35% of clinical development and plans to receive a 5.5-7% royalty on net sales and up to 30% of any upfront and milestone payments. At ASCO 2009 Chi, et al Phase II, open-label, randomized data in 81 metastatic hormone-refractory prostate cancer patients +/- docetaxel and prednisone: 7.26 versus 6.14 months for PFS, 23.82 versus 16.89 months for OS, disease control rates of 96% versus 75%, and 4% versus 17% progressive disease for the OGX-011 (n=40) and comparator arms (n=41), respectively. |
| **OGX-0427** (OncoGenex) | Multiple potential cancers: prostate, pancreas, breast, bladder, NSCLC | **Phase I** - OncoGenex advanced OGX-427 into Phase I studies in 2007. Heat shock protein 27 (Hsp27) is a cell survival protein that is over-produced in response to many cancer treatments, including hormone ablation therapy, chemotherapy, and radiation therapy. Increased Hsp27 production is observed in many human cancers, including prostate, non-small cell lung, breast, ovarian, bladder, renal, pancreatic, multiple myeloma, and liver cancers. Data from a Phase II solid tumors study were presented at ASCO 2009 (Hotte, et al): n=41 patients dosed as monotherapy and then in combination with docetaxel and the best response was stable disease for 4.7 months in an ovarian cancer patient. No objective responses were noted. Three prostate cancer patients had PSA declines of 43%, 58%, and 62%. A Phase II program is being planned. |

Source: Company reports and Wells Fargo Securities, LLC

| ISIS Pharmaceuticals Partnered/External Pipeline Summary Cont'd. | | |
|---|---|---|
| **Candidate** | **Indication** | **Stage And Summary** |
| **ATL/TV1102** (Antisense Therapeutics LTD; Teva Pharmaceuticals) | Multiple Sclerosis | **Phase II(a)** – In December 2001, Isis licensed ATL/TV1102 to Antisense Therapeutics Limited (ATL). ATL/TV1102 is a second-generation antisense inhibitor of CD49d, a subunit of VLA-4 (Very Late Antigen-4) and transmembrane lymphocytes adhesion receptor. VLA4 plays an important role in the inflammatory process by enabling lymphocyte adhesion to blood vessel walls and the subsequent migration of lymphocytes into tissue. In multiple sclerosis, VLA4 over-expression enables the inappropriate migration of lymphocytes into the central nervous system (CNS), contributing to white blood cells attacking the nerve cells. ATL has licensed this compound to Teva Pharmaceuticals and Isis expects to receive 33% of the sub-licenses in milestone payments and up to a 50% share of royalties. In a Phase II(a) study in patients with relapsed-remitting multiple sclerosis, after eight weeks ATL/TV1102 reduced the number of cumulative new active lesions by 54.4% (p=0.01) versus placebo as measured by magnetic resonance images. These results are comparable to Biogen/Elan's *Tysabri* . |
| **AIR 645** (Altair Therapeutics) | Asthma/Rhinitis | **Phase II(a)** – AIR 645, formerly ISIS 369645, is an inhaled, once-weekly, second-generation antisense drug that inhibits the alpha subunit of the interleukin 4 receptor, IL4R-alpha. Inhibiting the production of the IL4R-alpha inhibits the activity of two important cytokines in asthma: IL4 and IL13, that regulate inflammation, mucus overproduction, and airway hyper-responsiveness. AIR 645 is Isis' first inhaled antisense drug to enter into development. Isis granted Altair exclusive rights to develop this compound for respiratory diseases. On May 22, 2009, Altair reported positive Phase I safety results at the 2009 ATS meeting. No serious adverse events or dose-limiting toxicities were noted in 72 evaluable healthy volunteers. Phase II(a) data is expected in Q3 2010. |
| **LY2181308** (Eli Lilly) | Oncology | **Phase II** – One of the longest-standing relationships for Isis has been with Eli Lilly, an alliance initiated in 2001. LY2181308 is a second-generation antisense agent that targets the gene encoding survivin. Survivin is a 16 kDa protein, first described in 1997, and a member of the inhibitors of the apoptosis gene family. Survivin enables the survival of cells which would normally undergo programmed cell death by blocking apoptosis through the inhibition of initiator and effector caspases. It is selectively expressed during mitosis during G2/M phase and is localized to mitotic spindle microtubules and midbodies of dividing cells. Preclinical results with LY2181308 are among the first to demonstrate antitumor activity *in vivo* with a drug that specifically inhibits survivin expression. During 2008 Lilly commenced two Phase II studies: n=20 in relapsed/refractory Acute Myelogenous Leukemia and n=150 in combination with docetaxel in recurrent hormone refractory prostate cancer. |
| **MK-0608** (Merck & Co., Inc.) | Hepatitis C | **Phase I** - This compound was discovered through its collaboration with Merck for the treatment of Hepatitis C. A $1 million milestone was earned by Isis in December 2006. The collaboration began in 1998 and has been extended multiple times. |
| **iCo007** (iCo Therapeutics) | Ocular Disease | **Phase I** – In late 2007, iCo advanced iCo007 into clinical study. It targets the c-raf kinase, an enzyme important in the signal transduction pathway triggered by VEGF and other important growth factors. In preclinical studies, antisense inhibition of c-Raf kinase was associated with a reduction in the formation of new blood vessels in the eye, suggesting that c-Raf inhibition could be valuable in the treatment of both Age-related Macular Degeneration and diabetic retinopathy. An interim analyses in 2008 and 2009 suggested that the drug initially appears to be safe. In mid-2009, the Phase I study entered a fourth dosing cohort. This four-arm (no placebo), n=15 patient study is expected to conclude in early 2010. On December 9, iCo announced no severe adverse events have transpired in the study and a Phase II study is planned for 2010. |

Source: Company reports and Wells Fargo Securities, LLC

| ISIS Pharmaceuticals Partnered/External Pipeline Summary Cont'd. | | |
|---|---|---|
| **Candidate** | **Indication** | **Stage And Summary** |
| **EXC001** (Excaliard) | Fibrosis, wound healing | **Phase II -** EXC001 was discovered by Isis and is being developed by Excaliard Pharmaceuticals for the local treatment of fibrosis. Excaliard initiated a Phase I study during Q2 2009 and announced positive results on January 5, 2010. Excaliard plans to start three Phase II studies in 2010. |
| **ACHN 490** Aminoglycoside Program (Achaogen, Inc.) | Antibiotics | **Phase I** - In early 2006, Isis licensed its proprietary aminoglycosides program. Aminoglycosides inhibit bacterial protein synthesis and are used to treat serious bacterial infections. In exchange, Isis received $1.5 million of Achaogen stock. Achaogen is a biotechnology company focused on developing drugs to combat drug-resistant pathogens. |
| **BMS-844421** (PCSK9Rx; Bristol-Myers Squibb) | High cholesterol | **Phase I** – This development program is focused on Proprotein Convertase Subtilisin Kexin 9 (PCSK9). Deleting the PCSK9 protein results in an increase in LDL-C receptors and a significant lowering of LDL-C. Evaluation of PCSK9 gene knock-out rodents, as well as humans with a genetic mutation of PCSK9, demonstrates that these models have LDL-C levels that are 50% lower than normal. When the protein is intact more LDL-C receptors are present and able to absorb more LDL-C from the bloodstream. The program advanced from concept into INDA-enabling studies in approximately 15 months. |
| **ALT1103** (Antisense Therapeutics LTD) | Acromegaly and ocular diseases (diabetic retinopathy) | **Preclinical** - During 2007 ALT advanced ALT1103 into INDA-enabling toxicology studies and planned to complete them in 2009. ATL1103 is a second-generation antisense drug that inhibits growth hormone receptor expression which reduces hormone IGF-1 in blood. In preclinical studies over six weeks in monkeys, ALT1103 decreased IGF-1 by 35% versus placebo. |
| **ISIS 5320** (ImQuest Pharmaceuticals) | HIV Inhibitor (monotherapy or in combination with microbicides) | **Preclinical** - Isis licensed a non-antisense oligonucleotide compound for the development as an anti-HIV topical microbicide. ISIS 5320 specifically and potently inhibits the attachment of HIV to target cells by interfering with the interaction of HIV receptor gp120 and CD4 on target cells. Human studies have demonstrated the safety of ISIS 5320. ImQuest plans to globally market ISIS 5320 but focus on the developing world. |
| **Antogomir-122** (Regulus Therapeutics) | Immunology, oncology | **Discovery** - Antogomir-122 is a fully owned microRNA inhibitor of miR-122, an abundant liver-specific miRNA that has been implicated in HCV infection and oncology. Regulus Therapeutics is a 50/50 joint venture between Isis and Alnylam. |
| **Antisense collaboration** (Rosetta Genomics) | Liver cancer, hepatocellular carcinoma | **Discovery** - In February 2006 Isis announced a collaboration with Rosetta Genomics, a private Israeli biopharmaceutical company, to jointly collaborate on discovery and development of antisense drugs that regulate microRNAs for the treatment of hepatocellular carcinoma, the most prevalent form of liver cancer. |

Source: Company reports and Wells Fargo Securities, LLC

| ISIS Pharmaceuticals Internal Pipeline Summary | | |
|---|---|---|
| **Candidate** | **Indication** | **Stage And Summary** |
| **ISIS 401025** | Anticoagulation | **Preclinical** – ISIS 401025 is a second-generation ASO targeting prothrombin Factor II and has been shown to reduce thrombin generation and prolong PT and aPTT as a result of depleting prothrombin mRNA in preclinical models. |
| **ISIS 333611** | ALS | **Preclinical** – ISIS 333611, a second-generation antisense inhibitor of the mutant protein Cu/Zn superoxide dismutase (SOD1), a molecule associated with an aggressive form of amyotrophic lateral sclerosis (ALS, also called Lou Gehrig's disease), being developed with funding from the ALS Association (ALSA), as well as grants from the NIH and the Scripps Research Institute. Isis planned on starting a Phase I study in 2009. |
| **ISIS-EIF4ERx** (formerly Eli Lilly, LY2275796 ) | Oncology | **Phase I** – LY2275796 targets eukaryotic initiation factor-4E (eIF-4E), a protein that is over-expressed in a variety of cancers, including breast, head and neck, prostate, lung, bladder, colon, thyroid, and non-Hodgkin's lymphoma. eIF-4e facilitates the synthesis of tumor angiogenic factors, growth factors, and survival factors by selectively enhancing their translation. Based on scientific literature, there is a strong indication that eIF-4E may act as a critical switch in cancer progression. A Phase I study at MD Anderson in advanced solid tumors (n=40; ECOG 0 and 1 status) is expected to conclude by H1 2010. On December 9, 2009, Isis re-acquired the rights from Eli Lilly. Lilly has an option to reacquire the rights prior to Phase III. Isis is responsible for its clinical development. |
| **ISIS 353512** | Coronary artery disease, Crohn's disease, cancer cachexia, rheumatoid arthritis, end-stage renal disease, and cardiovascular disease | **Phase I** – ISIS 353512 is a generation 2.2 antisense drug that targets C-reactive protein (CRP). Generation 2.2 antisense inhibitors incorporate modified chemical motifs to optimize cellular enzyme activity, making them 3-10x more potent than the optimal second-generation inhibitors while they maintain the long half-life that supports infrequent dosing. In preclinical studies, ISIS 353512 produced dramatic suppression of liver and serum CRP levels. In August 2008, Isis initiated a Phase I study evaluating ISIS 353512's safety and pharmacokinetic profile. This is a ten-arm study in which seven arms are a 3:1 randomization versus placebo and three arms are 8:2 randomization versus placebo (n=58). While the Phase I study progresses, Isis plans on designing a Phase II program to assess the drug in a variety of diseases. |
| **ISIS-APOCIIIRx** | Hypertriglyceridemia | **Preclinical** - ISIS-APOCIIIRx a second-generation antisense inhibitor of apolipoprotein C-III (apoC-III), a key regulator of serum triglycerides (TG) levels. In preclinical studies, ISIS-APOCIIIRx mitigated symptoms of metabolic syndrome and reduced atherosclerosis in mice. |

Source: Company reports and Wells Fargo Securities, LLC

| ISIS Pharmaceuticals Internal Diabetes Pipeline Summary | | |
|---|---|---|
| **Candidate** | **Indication** | **Stage And Summary** |
| **ISIS 113715** | Type 2 diabetes mellitus | **Phase II** – ISIS 113715 is a second-generation antisense inhibitor of protein tyrosine phosphatase (PTP-1B), a target that has long been pursued as a treatment for Type II diabetes and has been found to be an undruggable target using traditional drug discovery methods due to structural similarities among closely related enzymes. PTP-1B is thought to potentiate diabetes and weight gain. Inhibition of PTP-1B may allow the insulin receptors to stay active longer, allowing more glucose uptake into cells, thus lowering levels in the blood stream leading to lower doses of insulin for patients. In a Phase II study, 200mg ISIS 113715 demonstrated a dose-dependent reduction in fasting glucose and a trend in lowering HbA1c in newly diagnosed Type II diabetic patients over a three-month dosing period. ISIS 113715 was the subject of a Phase II add-on to sulfonylurea study. Isis reported positive 13-week Phase II data on October 21, 2009, which produced significant reductions in short and medium term glucose control (but did not present HbA1c results) and LDL-C. The next step is a 26-week Phase II(b) study in 2010/2011. |
| **ISIS 388626** | Type I and/or II diabetes mellitus | **Phase I -** ISIS 388626 targets sodium-dependent glucose transporter type 2 (SGLT2) for the treatment of diabetes. Down-regulation of SGLT2 causes the kidney to reduce re-absorption of glucose, causing glucose to be excreted, and thus reducing blood glucose levels. The goal is to introduce a once-monthly formulation during Phase II studies. Preclinical data in multiple animal models indicates an 80% reduction in SGLT2 expression. Isis announced initiation of a Phase I study on February 5, 2009. |
| **ISIS-GCGRRx** (formerly ISIS 325568) | Diabetes | **Phase I** – Isis 325568 is an inhibitor of Glucagon receptor (GCGR) expression, a cellular receptor for glucagon and one of the counter-regulatory hormones that oppose the action of insulin and helps maintain normal blood glucose levels. Targeting GCGR may reverse the diabetes phenotype and have disease-modifying potential in humans. In addition, preclinical studies have demonstrated ISIS 325568's ability to increase glucagon-like peptide 1 as a secondary mechanism of action. Isis commenced a Phase I eight-arm study in September 2007 (prior to licensing the compound to Ortho-McNeil) and intended to establish proof of concept by incorporating a glucagon challenge test as well, thus demonstrating whether or not this compound will have adequate efficacy to progress. The study concluded in mid 2008. On March 1, 2010, Isis announced it had re-acquired the rights to this program from Ortho-McNeil. |
| **Unknown** ( formerly Ortho-McNeil/ J&J) | Metabolic disorders | **Preclinical** – As part of the Ortho-McNeil collaboration, antisense drugs are to be developed against two additional targets which are to be jointly identified. On March 1, 2010, Isis announced that this collaboration had ended. |
| **ISIS-GCCRRx** (formerly ISIS 377131) | Diabetes | **Preclinical** – The glucocorticoid receptor (GCCR) is an intracellular receptor for the steroid hormones of the glucocorticoid or GC family. Excessive glucocorticoid action causes a spectrum of clinical features such as obesity, insulin resistance, and glucose intolerance. Glucocorticoids promote breakdown of protein and fat from storage and result in excessive liver glucose production. Inhibiting this breakdown may have a positive effect on glucose, lipids, and body fat. ISIS 377131 advanced into INDA-enabling toxicology studies in 2007. On March 1, 2010, Isis announced it had re-acquired the rights to this program from Ortho-McNeil. |

Source: Company reports and Wells Fargo Securities, LLC

## Exhibit 2. Isis' Updated Income Statement

### ISIS Pharmaceuticals, Inc.

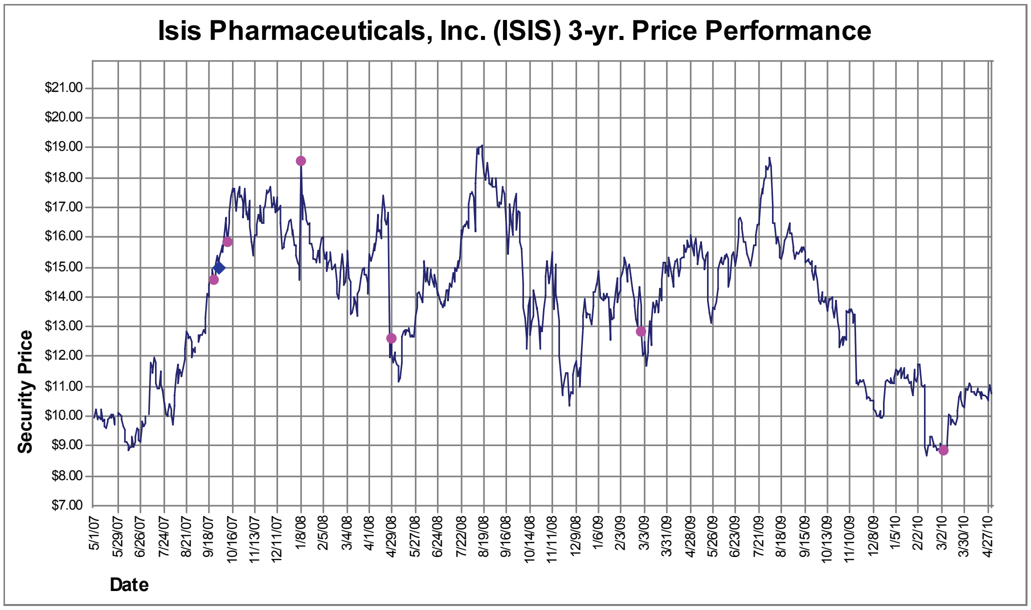
**Income Statement**

All figures in $ millions except per share amounts
FY ends December 31

| | FY 2007A | FY 2008A | FY 2009A | 2010E Q1:10A | 2010E Q2:10E | 2010E Q3:10E | 2010E Q4:10E | FY 2010E | FY 2011E | FY 2012E | FY 2013E |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Product Revenue** | | | | | | | | | | | |
| Revenue from Collaborative Agreements | 22.3 | 98.9 | 108.1 | 28.6 | 21.0 | 21.0 | 21.0 | 91.6 | 105.8 | 130.8 | 130.8 |
| Licensing & Royalty Revenue | 36.0 | 8.3 | 13.5 | 1.4 | 9.0 | 8.0 | 9.0 | 27.4 | 51.9 | 54.4 | 54.4 |
| Royalty Revenue - 301012 | - | 22.0 | - | - | - | - | - | - | - | 22.0 | 62.4 |
| Revenue from Affiliates | - | - | - | - | - | - | - | - | - | - | - |
| **Total Revenue** | **58.3** | **129.2** | **121.6** | **29.9** | **30.0** | **29.0** | **30.0** | **118.9** | **157.7** | **207.1** | **247.5** |
| % Change Yr/Yr | 138% | 121% | -6% | -5% | -3% | 8% | -7% | -2% | 33% | 31% | 20% |
| % Change Qtr/Qtr | N/A | N/A | N/A | -7% | 0% | -3% | 3% | N/A | N/A | N/A | N/A |
| **Operating Expenses** | | | | | | | | | | | |
| Cost of Goods Sold | - | - | - | - | - | - | - | - | - | - | - |
| Gross Margin | 58.3 | 129.2 | 121.6 | 29.9 | 30.0 | 29.0 | 30.0 | 118.9 | 157.7 | 207.1 | 247.5 |
| Gross Margin (%) | 85% | 85% | 85% | NA | NA | NA | NA | 85% | 85% | 85% | 85% |
| Research & Development | 78.2 | 106.4 | 134.6 | 32.0 | 38.0 | 35.0 | 39.0 | 144.0 | 154.0 | 157.0 | 160.0 |
| G&A | 13.1 | 13.8 | 14.5 | 2.8 | 3.5 | 3.7 | 4.0 | 14.0 | 15.0 | 20.0 | 21.0 |
| Compensation From Stock Options | - | - | - | - | - | - | - | - | - | - | - |
| Restructuring Activities | - | - | - | - | - | - | - | - | - | - | - |
| **Total Operating Expenses** | 91.3 | 120.2 | 149.1 | 34.8 | 41.5 | 38.7 | 43.0 | 158.0 | 169.0 | 177.0 | 181.0 |
| **Operating Income** | **($32.9)** | **$8.9** | **($27.5)** | **($4.9)** | **($11.5)** | **($9.7)** | **($13.0)** | **($39.1)** | **($11.3)** | **$30.1** | **$66.5** |
| Interest and Other Income, net | 4.2 | 0.1 | (4.2) | (3.3) | (2.3) | (2.4) | (2.5) | (10.4) | 8.0 | 15.2 | 13.2 |
| Income Before Taxes | ($28.8) | $9.1 | ($31.8) | ($8.2) | ($13.8) | ($12.1) | ($15.5) | ($49.5) | ($3.3) | $45.3 | $79.8 |
| Income Tax Expense (Benefit) | - | - | 3.2 | - | (1.0) | (2.0) | (1.0) | (2.5) | (0.5) | 6.8 | 12.0 |
| Rate (%) | - | - | 0% | 0% | -7% | -17% | 6% | 5% | 15% | 15% | 15% |
| **Net Loss Before Affect of Other** | **($28.8)** | **$9.1** | **($34.9)** | **($8.2)** | **($12.8)** | **($10.1)** | **($14.6)** | **($47.0)** | **($2.8)** | **$38.5** | **$67.8** |
| Loss Attributable to JVs (Symphony GenIsis, Regulus and Discontinued Operations of Ibis). | ($107.6) | ($3.7) | $190.0 | ($1.5) | $0.9 | $1.1 | $1.2 | $1.7 | $1.7 | $1.7 | $1.7 |
| **Net Profit (Loss) Avail to Common** | **($136.3)** | **$5.4** | **$155.1** | **($9.7)** | **($11.9)** | **($8.9)** | **($13.4)** | **($45.3)** | **($1.1)** | **$40.2** | **$69.5** |
| GAAP Diluted EPS | **($1.63)** | **($0.19)** | **$1.58** | **($0.10)** | **($0.12)** | **($0.09)** | **($0.13)** | **($0.43)** | **($0.01)** | **$0.33** | **$0.55** |
| GAAP Taxed EPS | ($1.63) | $0.04 | $0.77 | ($0.10) | ($0.12) | ($0.09) | ($0.13) | ($0.43) | ($0.01) | $0.26 | $0.44 |
| **Non-GAAP Net Profit (Loss)** | | ($1.51) | $154.3 | ($9.7) | ($8.3) | ($5.4) | ($11.4) | ($31.3) | $14.9 | $56.2 | $85.5 |
| Non-GAAP Diluted EPS | | ($0.01) | $1.61 | ($0.08) | ($0.07) | ($0.05) | ($0.10) | ($0.27) | $0.14 | $0.52 | $0.77 |
| Non-GAAP Basic EPS | | ($0.02) | $1.58 | ($0.10) | (0.08) | ($0.05) | ($0.11) | ($0.31) | $0.14 | $0.52 | $0.77 |
| Basic Shares | 83.7 | 94.6 | 98.1 | 99.0 | 101.0 | 103.0 | 105.0 | 102.0 | 105.0 | 108.0 | 111.0 |
| Diluted Shares | 85.0 | 97.4 | 113.1 | 114.8 | 115.8 | 116.8 | 117.8 | 116.3 | 119.3 | 122.3 | 125.3 |

Source: Company reports and Wells Fargo Securities, LLC estimates

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 5/1/2007 | | Reames | | | |
| | 5/1/2007 | NA | 1 | 14.00 | 14.00 | 9.92 |
| ● | 9/24/2007 | NA | 1 | 18.00 | 18.00 | 14.55 |
| ◆ | 9/28/2007 | NA | NR | NE | NE | 14.97 |
| ●◆ | 10/10/2007 | 15.86 | 1 | 22.00 | 25.00 | 15.86 |
| ● | 1/8/2008 | 14.58 | 1 | 30.00 | 34.00 | 18.58 |
| ● | 4/28/2008 | 11.99 | 1 | 20.00 | 23.00 | 12.58 |
| ● | 2/27/2009 | 13.69 | 1 | 20.00 | 22.00 | 12.86 |
| ● | 3/3/2010 | 8.91 | 1 | 15.00 | 17.00 | 8.84 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- ❐ Split Adjustment

**Rating Code Key**
- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

# Additional Information Available Upon Request

I certify that:
1) All views expressed in this research report accurately reflect my personal views about any and all of the subject securities or issuers discussed; and
2) No part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by me in this research report.

- Wells Fargo Securities, LLC maintains a market in the common stock of Isis Pharmaceuticals, Inc.

**ISIS:** Risks include failure of clinical trials and changes in mipomersen regulatory requirements.

Wells Fargo Securities, LLC does not compensate its research analysts based on specific investment banking transactions. Wells Fargo Securities, LLC's research analysts receive compensation that is based upon and impacted by the overall profitability and revenue of the firm, which includes, but is not limited to investment banking revenue.

## STOCK RATING

**1=Outperform:** The stock appears attractively valued, and we believe the stock's total return will exceed that of the market over the next 12 months. BUY
**2=Market Perform:** The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD
**3=Underperform:** The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

## SECTOR RATING

**O=Overweight:** Industry expected to outperform the relevant broad market benchmark over the next 12 months.
**M=Market Weight:** Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.
**U=Underweight:** Industry expected to underperform the relevant broad market benchmark over the next 12 months.

## VOLATILITY RATING

**V** = A stock is defined as volatile if the stock price has fluctuated by +/-20% or greater in at least 8 of the past 24 months or if the analyst expects significant volatility. All IPO stocks are automatically rated volatile within the first 24 months of trading.

As of: May 7, 2010

| | |
|---|---|
| 45% of companies covered by Wells Fargo Securities, LLC Equity Research are rated Outperform. | Wells Fargo Securities, LLC has provided investment banking services for 42% of its Equity Research Outperform-rated companies. |
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SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE

May 7, 2010

WELLS FARGO SECURITIES

# *Equity Research*

## Leap Wireless International Inc.

**LEAP: Reports Strong Q1 Sub Growth--Lowering Estimates**

**Market Perform / V**

Sector: Wireless Carriers
Market Weight

- LEAP's Q1 results were characterized by much-better subscriber growth as it benefited from a fairly quiet prepay promotional environment and customers' higher disposable income trends. Despite this performance, we remain at a Market Perform rating on the shares. With both PCS and LEAP we have limited visibility as to the remainder of 2010 trends given the volitility in the churn and ARPU metrics. While we were encouraged that the new Sprint plans did not lower the bar for unlimited voice/text service, we still believe there will be promotion and marketing activities around new competitor price plans (at Sprint and others) that could cause LEAP to lose some of the share of gross adds. Our new 2010E revenue and EBITDA are $2.7B and $595MM from $2.76B and $607MM. Our new 2011E revenue and EBITDA are $2.92B and $698MM from $3.09B and $742 MM. Valuation range goes from $13-15 to $17-18.
- **Q1 RESULTS--**LEAP reported 446,000 net adds versus our estimate of 359,000. 249,000 came from voice and 197,000 came from broadband. Gross adds were slightly better at 1.1MM versus our 1.05MM estimate. Churn of 4.5% was better than our 4.7%. ARPU was lower at $37.96 versus our $38.41 estimate. Weaker ARPU offset the greater sub growth in terms of total revenue for Q1. Specifically, total revenue was $654MM versus our $659MM estimate, despite better sub growth. EBITDA for Q1 was $123MM including the one-time impact of $4MM charge related to store and staffing adjustments.
- **EXPECT Q2 RESULTS TO SHOW TYPICAL SEASONALITY--**While management would not give specific guidance as to Q2 expectations, we would note given that its new price plans only began on March 23, we expect the momentum coming from this promotion to have continued through most of April and early May. Offsetting this better gross add promotion is higher seasonal churn. We note churn increased 90bps between Q1 and Q2 in 2009. While we do not expect as much of an increase in 2010--directionally we do believe it will go higher in Q2 (which management also confirmed).
- **LEAP OFFERS SOME NEAR-TERM GUIDANCE--**Leap sees margin improving throughout the year as Broadband and Expansion markets improve from breakeven. Leap expects strong sequential EBITDA growth of approximately 45% in Q2 on these trends and cost management. For the full year, Leap expects to reap $175-225MM of cost and productivity benefits. However, we note all these savings will not be seen in EBITDA expansion--some is to be used to reinvest in the business and help offset continued ARPU deterioration. Leap expects continued ARPU pressure from the popularity of the Broadband and PayGo products to continue to weigh on ARPU throughout the year, but the H2 introduction of smartphones should help slow the decline.

### *Earnings Estimate Revised Down*

| | 2009A | 2010E | | 2011E | |
|---|---|---|---|---|---|
| **EBITDA** | | **Curr.** | **Prior** | **Curr.** | **Prior** |
| **Q1** (Mar.) | $1.42 | **$1.62 A** | **1.78** | **$2.24** | **NE** |
| **Q2** (June) | 1.95 | **2.26** | **1.98** | **2.39** | **NE** |
| **Q3** (Sep.) | 1.61 | **1.97** | **2.10** | **2.27** | **NE** |
| **Q4** (Dec.) | 1.71 | **1.96** | **2.12** | **2.18** | **NE** |
| **FY** | $6.70 | **$7.81** | **7.98** | **$9.08** | **9.65** |
| **CY** | $6.70 | $7.81 | | $9.08 | |
| **FY P/EBITDA** | 2.5x | 2.2x | | 1.9x | |
| **Rev.(MM)** | $2,383 | $2,690 | | $2,922 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

| | |
|---|---|
| Ticker | LEAP |
| Price (05/06/2010) | $16.78 |
| 52-Week Range: | $11-43 |
| Shares Outstanding: (MM) | 67.7 |
| Market Cap.: (MM) | $1,136.0 |
| S&P 500: | 1,128.15 |
| Avg. Daily Vol.: | 2,100,200 |
| Dividend/Yield: | $0.00/0.0% |
| LT Debt: (MM) | $2,760.0 |
| LT Debt/Total Cap.: | 35.0% |
| ROE: | 5.0% |
| 3-5 Yr. Est. Growth Rate: | 28.0% |
| CY 2010 Est. P/EBITDA-to-Growth: | 0.1x |
| Last Reporting Date: | 05/06/2010 After Close |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

**Valuation Range: $17.00 to $18.00** **from $13.00 to $15.00**
Our range of $17-18 per share is based on 5.0-5.1x 2011E EBITDA. Risks include increasing competition, higher-than-expected capex with new markets, ARPU and churn pressure due to competition and weak economy.

**Investment Thesis:**
We believe LEAP faces many headwinds beyond its immediate control, driven by the changing competitive landscape and pricing approach around the prepay space. As a result, we struggle with catalysts to drive further multiple expansion.

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**Please see page 4 for rating definitions, important disclosures and required analyst certifications**

## Company Description:

Based in San Diego, California LEAP is a wireless service provider with 1.6 million customers as of the end of June. LEAP was incorporated in 1998 as a wholly owned subsidiary of Qualcomm Corporation and was ultimately distributed to QCOM shareholders through a taxable dividend. In April 2003, LEAP was forced to file for bankruptcy protection after its leverage became too high (and the capital markets closed down). The company emerged from bankruptcy protection in October 2003 and now operates with a much stronger balance sheet. The company markets under the "Cricket" brand name and offers a unique approach to wireless pricing with three main price plans ranging from $35 - 45 per month. Each of these price plans includes unlimited local anytime minutes. Through these offerings, LEAP is attempting to target what it considers to be an underserved target market, those users looking to abandon their traditional wireline service. Today, the company offers service in 34 U.S. markets with 27.2 million covered POPs.

### SUMMARY OF ESTIMATES

| ($ in millions) | Q1 '10A | Q1 '10E | Q1 '09A | Y/Y% |
|---|---|---|---|---|
| Service Revenue | 584.8 | 591.6 | 514.1 | 13.8% |
| Total Revenue | 654.0 | 659.3 | 587.0 | 11.4% |
| Adjusted EBITDA | 123.0 | 134.9 | 96.9 | 27.0% |
| Adjusted EBITDA Margin | 21.0% | 22.8% | 18.8% | |
| Adjusted EPS | ($0.90) | ($0.90) | ($0.74) | |
| Operational Statistics | | | | |
| Subscriber Gross Additions ('000) | 1,133 | 1,050 | 890 | 27.3% |
| Subscriber Net Additions ('000) | 446 | 359 | 493 | -9.5% |
| Churn | 4.5% | 4.7% | 3.3% | |
| Average Revenue Per User (ARPU) | $37.96 | $38.41 | $42.21 | -10.1% |

Source: Wells Fargo Securities, LLC estimates and Company reports

### SUMMARY OF ESTIMATE CHANGES

| ($ in millions) | Q2 '10E NEW | Q2 '10E OLD | 2010E NEW | 2010E OLD | 2011E NEW | 2011E OLD |
|---|---|---|---|---|---|---|
| Service Revenue | 610.7 | 617.6 | 2,423.1 | 2,496.7 | 2,646.5 | 2,820.2 |
| Total Revenue | 676.7 | 681.9 | 2,689.9 | 2,762.1 | 2,922.2 | 3,087.7 |
| Adjusted EBITDA | 171.8 | 150.5 | 594.5 | 607.1 | 698.1 | 742.4 |
| Adjusted EBITDA Margin | 28.1% | 24.4% | 24.5% | 24.3% | 26.4% | 26.3% |
| Adjusted Diluted EPS | ($0.38) | ($0.73) | ($2.73) | ($2.94) | ($1.95) | ($1.80) |
| Operational Statistics | | | | | | |
| Subscriber Gross Additions ('000) | 1,000 | 950 | 4,033 | 3,950 | 3,733 | 3,700 |
| Subscriber Net Additions ('000) | 125 | 185 | 877 | 972 | 404 | 670 |
| Churn | 5.4% | 4.8% | 4.9% | 4.6% | 4.6% | 4.1% |
| Average Revenue Per User (ARPU) | $37.27 | $38.08 | $37.03 | $38.00 | $36.29 | $37.24 |

Source: Wells Fargo Securities, LLC estimates

**Leap Wireless International Inc.**
($ in millions)

| INCOME STATEMENT | 2007 | 2008 | 1Q09 | 2Q09 | 3Q09 | 4Q09 | 2009 | 1Q10 | 2Q10E | 3Q10E | 4Q10E | 2010E | 2011E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Service revenue | **1,395.7** | **1,709.1** | 514.1 | 541.6 | 541.3 | 547.0 | **2,143.9** | 584.8 | 610.7 | 607.3 | 620.2 | **2,423.1** | **2,646.5** |
| *y/y growth %* | *45.9%* | *22.5%* | *28.9%* | *29.8%* | *24.6%* | *19.3%* | *25.4%* | *13.8%* | *12.8%* | *12.2%* | *13.4%* | *13.0%* | *9.2%* |
| *seq. growth %* | | | *12.1%* | *5.4%* | *-0.1%* | *1.0%* | | *6.9%* | *4.4%* | *-0.6%* | *2.1%* | | |
| Equipment revenue | **235.1** | **249.8** | 73.0 | 55.8 | 58.2 | 52.3 | **239.3** | 69.1 | 66.0 | 64.0 | 67.7 | **266.8** | **275.6** |
| *y/y growth %* | *11.5%* | *6.2%* | *5.1%* | *-3.3%* | *-6.4%* | *-13.4%* | *-4.2%* | *-5.3%* | *18.2%* | *10.0%* | *29.3%* | *11.5%* | *3.3%* |
| **Total revenue** | 1,630.8 | 1,958.9 | **587.0** | **597.4** | **599.5** | **599.3** | 2,383.2 | **654.0** | **676.7** | **671.4** | **687.9** | 2,689.9 | 2,922.2 |
| *y/y growth %* | *39.7%* | *20.1%* | *25.3%* | *25.8%* | *20.7%* | *15.5%* | *21.7%* | *11.4%* | *13.3%* | *12.0%* | *14.8%* | *12.9%* | *8.6%* |
| Cost of service | **382.0** | **485.2** | 143.5 | 153.8 | 155.8 | 152.4 | **605.5** | 165.3 | 158.8 | 164.0 | 167.5 | **655.6** | **714.6** |
| *Gross service margin %* | *72.6%* | *71.6%* | *72.1%* | *71.6%* | *71.2%* | *72.1%* | *71.8%* | *71.7%* | *74.0%* | *73.0%* | *73.0%* | *72.9%* | *73.0%* |
| Cost of equipment | **406.0** | **465.4** | 157.8 | 127.8 | 133.5 | 142.2 | **561.3** | 168.1 | 161.6 | 160.0 | 169.2 | **658.9** | **689.1** |
| *Gross equipment margin %* | *-72.7%* | *-86.3%* | *-116.2%* | *-128.9%* | *-129.4%* | *-171.7%* | *-134.5%* | *-143.1%* | *-145.0%* | *-150.0%* | *-150.0%* | *-147.0%* | *-150.0%* |
| Selling and marketing | **202.9** | **290.3** | 101.9 | 95.2 | 109.8 | 98.3 | **405.3** | 110.8 | 103.8 | 109.3 | 111.6 | **435.6** | **449.9** |
| *S&M % of service revenue* | *14.5%* | *17.0%* | *19.8%* | *17.6%* | *20.3%* | *18.0%* | *18.9%* | *18.9%* | *17.0%* | *18.0%* | *18.0%* | *18.0%* | *17.0%* |
| General and administrative | **247.7** | **304.1** | 86.9 | 82.8 | 78.8 | 77.0 | **325.5** | 86.8 | 80.6 | 88.1 | 89.9 | **345.4** | **370.5** |
| *G&A % of service revenue* | *17.7%* | *17.8%* | *16.9%* | *15.3%* | *14.6%* | *14.1%* | *15.2%* | *14.8%* | *13.2%* | *14.5%* | *14.5%* | *14.3%* | *14.0%* |
| EBITDA | **362.9** | **378.5** | 85.2 | 127.4 | 110.5 | 119.8 | **443.0** | 115.8 | 159.8 | 137.9 | 137.7 | **551.3** | **650.1** |
| Plus: Stock-based compensation | **29.3** | **35.2** | 11.7 | 10.4 | 11.0 | 9.6 | **42.7** | 7.2 | 12.0 | 12.0 | 12.0 | **43.2** | **48.0** |
| **Adjusted EBITDA** | 392.3 | 413.7 | **96.9** | **137.8** | **121.5** | **129.5** | 485.7 | **123.0** | **171.8** | **149.9** | **149.7** | 594.5 | 698.1 |
| *Adjusted EBITDA Margin %* | *28.1%* | *24.2%* | *18.8%* | *25.5%* | *22.4%* | *23.7%* | *22.7%* | *21.0%* | *28.1%* | *24.7%* | *24.1%* | *24.5%* | *26.4%* |
| *y/y growth %* | *5.0%* | *-13.9%* | *-36.7%* | *-0.5%* | *0.1%* | *19.4%* | *-6.4%* | *11.6%* | *10.5%* | *10.0%* | *2.0%* | *8.3%* | *7.5%* |
| Depreciation and amortization | **302.2** | **331.4** | 89.7 | 99.6 | 107.9 | 113.5 | **410.7** | 109.2 | 122.1 | 121.5 | 124.0 | **476.9** | **529.3** |
| *D&A % of service revenue* | *21.7%* | *19.4%* | *17.5%* | *18.4%* | *19.9%* | *20.7%* | *19.2%* | *18.7%* | *20.0%* | *20.0%* | *20.0%* | *19.7%* | *20.0%* |
| Gain (loss) on disposal of assets and other | **(0.5)** | **(0.4)** | 3.6 | (1.6) | (1.2) | (1.9) | **(1.1)** | (1.5) | (0.5) | (0.5) | (0.5) | **(3.0)** | **(2.0)** |
| Operating income | **60.3** | **46.7** | (1.0) | 26.3 | 1.4 | 4.5 | **31.2** | 5.1 | 37.2 | 16.0 | 13.1 | **71.4** | **118.8** |
| *Operating margin %* | *3.7%* | *2.4%* | *-0.2%* | *4.4%* | *0.2%* | *0.7%* | *1.3%* | *0.8%* | *5.5%* | *2.4%* | *1.9%* | *2.7%* | *4.1%* |
| Minority interests in consolidated subs | **1.8** | **(4.9)** | 0.0 | 0.0 | 0.0 | 0.0 | **0.0** | 0.0 | 0.0 | 0.0 | 0.0 | **0.0** | **0.0** |
| Equity in net loss of investee | **(2.3)** | **(0.3)** | 1.5 | 0.5 | 1.0 | 1.0 | **3.9** | 0.6 | 1.0 | 1.0 | 1.0 | **3.6** | **4.0** |
| Interest income | **28.9** | **14.6** | 0.9 | 0.6 | 0.7 | 1.5 | **3.8** | 0.4 | 0.5 | 0.5 | 0.5 | **1.9** | **2.0** |
| Interest expense | **(121.2)** | **(158.3)** | (41.9) | (49.1) | (59.1) | (60.3) | **(210.4)** | (60.3) | (60.0) | (60.0) | (60.0) | **(240.3)** | **(240.0)** |
| Other expense, net | **(6.0)** | **(7.0)** | (0.1) | (26.4) | (0.0) | 0.6 | **(25.8)** | 0.0 | 0.0 | 0.0 | 0.0 | **0.0** | **0.0** |
| Pre-tax income | **(38.6)** | **(109.2)** | (40.4) | (48.0) | (56.0) | (52.8) | **(197.3)** | (54.2) | (21.3) | (42.5) | (45.4) | **(163.3)** | **(115.2)** |
| Income taxes | **(37.4)** | **(38.6)** | (6.9) | (13.2) | (9.4) | (11.2) | **(40.6)** | (11.3) | (4.3) | (8.5) | (9.1) | **(33.1)** | **(23.0)** |
| Effective tax rate % | -96.9% | -35.4% | -17.0% | -27.5% | -16.7% | -21.2% | -20.6% | -20.9% | -20.0% | -20.0% | -20.0% | -20.3% | -20.0% |
| Accretion of redeembable of noncontrol ints | | | (2.9) | (1.6) | 0.8 | 2.1 | | (2.6) | (3.0) | (3.0) | (3.0) | | |
| Net income to common | **(75.9)** | **(147.8)** | (50.2) | (62.8) | (64.5) | (61.9) | **(239.4)** | (68.0) | (28.6) | (54.0) | (57.4) | **(208.1)** | **(150.3)** |
| **Diluted EPS** | **($1.13)** | **($2.17)** | **($0.74)** | **($0.89)** | **($0.85)** | **($0.82)** | **($3.30)** | **($0.90)** | **($0.38)** | **($0.71)** | **($0.75)** | **($2.73)** | **($1.95)** |
| EBITDA / Share | $5.85 | $6.09 | $1.42 | $1.95 | $1.61 | $1.71 | $6.70 | $1.62 | $2.26 | $1.97 | $1.96 | $7.81 | $9.08 |
| Diluted shares | **67.1** | **67.9** | 68.2 | 70.5 | 75.6 | 75.6 | **72.5** | 75.8 | 76.0 | 76.2 | 76.4 | **76.1** | **76.9** |

Source: Wells Fargo Securities, LLC estimates and Company reports

# Required Disclosures


| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 5/1/2007 | | Powell | | | |
| | 5/1/2007 | NA | 1 | 75.00 | 83.00 | 76.72 |
| ● | 5/8/2007 | NA | 1 | 95.00 | 103.00 | 79.46 |
| ▼ ● | 8/7/2007 | NA | 2 | 65.00 | 75.00 | 80.36 |
| ● | 9/4/2007 | 83.47 | 2 | 79.00 | 93.00 | 83.47 |
| ● | 11/21/2007 | 32.17 | 2 | 31.00 | 35.00 | 32.06 |
| ● | 12/14/2007 | 34.14 | 2 | 34.00 | 39.00 | 33.28 |
| ▼ ● | 1/29/2008 | 39.80 | 3 | 26.00 | 30.00 | 38.85 |
| ● | 2/28/2008 | 42.28 | 3 | 27.00 | 31.00 | 42.28 |
| ▲ ● | 3/13/2008 | 43.85 | 2 | 41.00 | 47.00 | 42.92 |
| ● | 4/8/2008 | NA | 2 | 50.00 | 57.00 | 53.50 |
| ● | 5/9/2008 | 54.81 | 2 | 54.00 | 59.00 | 54.48 |
| ● | 8/6/2008 | 44.98 | 2 | 40.00 | 49.00 | 45.69 |
| ■ | 9/15/2008 | | Fritzsche | | | |
| ● | 11/5/2008 | 28.75 | 2 | 31.00 | 35.00 | 28.75 |
| ▲ ● | 1/5/2009 | 28.46 | 1 | 35.00 | 37.00 | 30.79 |
| ● | 3/19/2009 | 36.80 | 1 | 39.00 | 40.00 | 37.34 |
| ▼ ● | 8/7/2009 | 22.59 | 2 | 17.00 | 19.00 | 17.06 |
| ● | 11/6/2009 | 13.03 | 2 | 13.00 | 15.00 | 12.66 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- □ Split Adjustment

**Rating Code Key**
- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

# Additional Information Available Upon Request

I certify that:
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**2=Market Perform:** The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD
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**O=Overweight:** Industry expected to outperform the relevant broad market benchmark over the next 12 months.
**M=Market Weight:** Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.
**U=Underweight:** Industry expected to underperform the relevant broad market benchmark over the next 12 months.

**VOLATILITY RATING**
**V** = A stock is defined as volatile if the stock price has fluctuated by +/-20% or greater in at least 8 of the past 24 months or if the analyst expects significant volatility. All IPO stocks are automatically rated volatile within the first 24 months of trading.

As of: May 7, 2010

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May 7, 2010

# *Equity Research*

## MLPs: Thoughts On The Sell-Off

Master Limited Partnerships

- **Correction Driven By Broader Market Factors.** Since 5/3/10, the Wells Fargo Securities MLP Index is off 10% (as of 5/6/10) compared to 6% for the S&P 500. Many sector specific reasons have been thrown about to explain the pullback. However, we believe weakness is being driven by broader market issues including: (1) overall market weakness, (2) widening credit spreads due to contagion fears around Greece, and (3) a decrease in crude oil prices. Lastly, (as we pointed our in our May Monthly) MLPs were poised for some price rationalization, having reached fair value from a valuation standpoint after a torrid run.

- **MLP Specific Factors Driving Weakness.** To review, the weakness in MLPs is likely due to a combination of the following factors. (1) A large indiscriminate seller was in the market on 5/5/10, (2) many MLPs traded ex-dividend on 5/5/10, which oftentimes creates selling pressure, (3) crude oil prices decreased, pulling the energy tape lower, (4) sector weakness may have triggered stop loss selling among some investors, which begets more selling, and (5) credit spreads widened, which is a key driver of MLP performance.

- **Weakness Highlights Risks In MLP Investing.** The selloff highlights some of the risks and drivers in MLPs including the sector's relative illiquidity which exaggerates price movements in both directions, in our view. We would remind investors that MLP correlations to the overall stock market (0.95 to the S&P500), crude oil prices (correlation of 0.85), and high yield credit spreads (0.86) have been meaningful over the last year. To the extent that the overall market continues to be volatile, crude oil prices continue to retreat and the credit market rally is over and reversing, MLPs could experience further headwinds.

- **A Buying Opportunity – MLP Fundamentals Are Solid - Focus On Quality.** We view this correction as an opportunity to build positions in high quality names. To the extent new entrants to the sector were reluctant to invest given the strong run up in prices, this pullback creates an attractive entry point, in our view. Notably, in spite of the macro headwinds, MLP fundamentals remain solid as evidenced by the strong earnings season to date (10 out 15 in-line or above forecast and median year/year distribution growth of 3.1%).

- **What Looks Especially Attractive?** In addition to our top picks of EPD ($32.62), ETE ($31.72), GEL ($17.89), SPH (44.21), SXL ($63.19) (see MLP Monthly dated 5/6/10), we would highlight ENP ($17.59), MMP ($43.92), OKS ($57.43), PAA ($53.99), RGNC ($20.99), and NGLS ($24.68).

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## Ratings & Assumptions

| Sector | Company | Ticker | Price 5/07/2010 | Valuation Range Low | Valuation Range High | Total Return | Our Rating | Valuation Assumptions ROR | Valuation Assumptions LT Growth | Valuation Assumptions P/DCF | Current Yield | Target Yield | 3-Yr Est. Distrib CAGR |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Large Cap Pipeline MLPs | SUNOCO LOGISTICS PRTNRS L P | SXL | $63.19 | $75 | $79 | 29% | Outperform | 8.5% | 1.3% | 12.0x | 6.9% | 6.2% | 9.6% |
| | KINDER MORGAN MANAGEMENT LLC | KMR | $55.26 | $63 | $67 | 26% | Outperform | 8.5% | 1.3% | 14.0x | 7.7% | 7.0% | 4.2% |
| | ENERGY TRANSFER PARTNERS -LP | ETP | $45.45 | $51 | $55 | 24% | Outperform | 8.5% | 1.3% | 14.5x | 7.9% | 6.7% | 2.9% |
| | ENTERPRISE PRODS PRTNER -LP | EPD | $32.62 | $36 | $39 | 22% | Outperform | 8.5% | 1.9% | 12.5x | 7.0% | 6.3% | 5.6% |
| | MAGELLAN MIDSTREAM PRTNRS LP | MMP | $43.92 | $48 | $52 | 21% | Outperform | 8.5% | 2.5% | 15.0x | 6.5% | 6.1% | 5.4% |
| | BOARDWALK PIPELINE PRTNRS-LP | BWP | $27.50 | $30 | $32 | 20% | Market Perform / V | 8.5% | 1.3% | 13.0x | 7.3% | 6.8% | 5.8% |
| | ONEOK PARTNERS -LP | OKS | $57.43 | $63 | $66 | 20% | Market Perform | 8.5% | 1.3% | 13.5x | 7.7% | 7.1% | 3.2% |
| | ENBRIDGE ENERGY PRTNRS -LP | EEP | $47.18 | $49 | $54 | 18% | Market Perform / V | 8.5% | 1.0% | 11.5x | 8.4% | 7.9% | 1.8% |
| | NUSTAR ENERGY LP | NS | $57.00 | $61 | $64 | 17% | Market Perform | 9.0% | 1.9% | 14.5x | 7.5% | 6.9% | 3.3% |
| | WILLIAMS PARTNERS LP | WPZ | $37.84 | $40 | $43 | 17% | Outperform / V | 8.5% | 1.3% | 8.0x | 6.7% | 6.5% | 5.8% |
| | ENBRIDGE ENERGY MGMT LLC | EEQ | $47.63 | $49 | $54 | 17% | Market Perform / V | 8.5% | 1.0% | 11.5x | 8.4% | 7.9% | 1.8% |
| | PLAINS ALL AMER PIPELNE -LP | PAA | $53.99 | $56 | $60 | 14% | Outperform | 8.5% | 1.3% | 14.5x | 6.9% | 6.6% | 4.7% |
| | BUCKEYE PARTNERS LP | BPL | $54.63 | $55 | $59 | 11% | Market Perform | 8.5% | 1.7% | 12.5x | 6.9% | 6.8% | 3.9% |
| | KINDER MORGAN ENERGY -LP | KMP | $63.02 | $63 | $67 | 10% | Market Perform | 8.5% | 1.3% | 14.0x | 6.8% | 7.0% | 4.2% |
| | EL PASO PIPELINE PARTNERS LP | EPB | $26.34 | $25 | $27 | 5% | Market Perform / V | 8.5% | 1.3% | 11.5x | 5.8% | 6.1% | 11.0% |
| | SPECTRA ENERGY PARTNERS LP | SEP | $30.68 | $28 | $30 | 0% | Market Perform / V | 8.5% | 1.3% | 13.5x | 5.5% | 6.1% | 9.2% |
| | **Large Cap Pipeline MLP Median** | | | | | **17%** | | **8.5%** | **1.3%** | **13.3x** | **6.9%** | **6.8%** | **4.5%** |
| Small Cap Pipeline MLPs | BLUEKNIGHT ENERGY PRTNRS LP | BKEP | $8.90 | $12 | $14 | 53% | Outperform / V | 10.5% | 1.3% | 13.0x | - | 9.6% | - |
| | GENESIS ENERGY -LP | GEL | $17.89 | $23 | $24 | 40% | Outperform / V | 9.5% | 1.3% | 12.0x | 8.2% | 6.8% | 9.9% |
| | MARTIN MIDSTREAM PARTNERS LP | MMLP | $28.75 | $34 | $36 | 32% | Outperform / V | 10.5% | 1.3% | 10.5x | 10.4% | 8.6% | 3.3% |
| | EXTERRAN PARTNERS LP | EXLP | $22.55 | $25 | $27 | 24% | Outperform / V | 9.5% | 1.3% | 10.5x | 8.2% | 7.7% | 5.1% |
| | DUNCAN ENERGY PARTNERS LP | DEP | $24.78 | $27 | $30 | 22% | Market Perform / V | 8.5% | 2.5% | 13.0x | 7.2% | 6.4% | 3.2% |
| | TRANSMONTAIGNE PARTNERS LP | TLP | $27.59 | $30 | $32 | 21% | Outperform / V | 9.5% | 1.3% | 10.0x | 8.7% | 8.1% | 4.2% |
| | HOLLY ENERGY PARTNERS LP | HEP | $43.15 | $45 | $47 | 14% | Market Perform / V | 9.5% | 1.3% | 13.0x | 7.6% | 7.4% | 6.4% |
| | WILLIAMS PIPELINE PRTNRS -LP | WMZ | $28.55 | $30 | $32 | 13% | Market Perform | 8.5% | 1.3% | 14.5x | 4.7% | 4.3% | 6.6% |
| | TC PIPELINES LP | TCLP | $36.47 | $37 | $39 | 12% | Market Perform | 10.0% | 1.9% | 10.5x | 8.0% | 8.1% | 4.3% |
| | **Small Cap Pipeline MLP Median** | | | | | **22%** | | **9.5%** | **1.3%** | **12.0x** | **8.1%** | **7.7%** | **4.7%** |
| Gathering & Processing ML | QUICKSILVER GAS SERVICES LP | KGS | $19.19 | $23 | $25 | 34% | Outperform / V | 9.5% | 1.3% | 11.0x | 8.1% | 7.8% | 10.9% |
| | CROSSTEX ENERGY LP | XTEX | $9.83 | $11 | $14 | 30% | Market Perform / V | 11.0% | 1.3% | 6.0x | - | 9.6% | - |
| | REGENCY ENERGY PARTNERS LP | RGNC | $20.99 | $24 | $27 | 30% | Outperform / V | 9.0% | 1.3% | 13.0x | 8.5% | 7.1% | 4.9% |
| | TARGA RESOURCES PARTNERS LP | NGLS | $24.68 | $27 | $29 | 22% | Outperform / V | 10.0% | 1.3% | 9.0x | 8.4% | 7.7% | 5.3% |
| | COPANO ENERGY LLC | CPNO | $24.00 | $25 | $28 | 20% | Outperform / V | 10.0% | 2.5% | 10.5x | 9.6% | 8.7% | 0.0% |
| | MARKWEST ENERGY PARTNERS LP | MWE | $28.89 | $30 | $33 | 18% | Market Perform / V | 10.0% | 2.5% | 10.0x | 8.9% | 8.1% | 2.3% |
| | ATLAS PIPELINE PARTNER LP | APL | $12.95 | $13 | $17 | 16% | Market Perform / V | 12.0% | 1.3% | 7.5x | - | - | - |
| | EAGLE ROCK ENERGY PARTNRS LP | EROC | $6.10 | $5 | $8 | 11% | Market Perform / V | 11.0% | 1.3% | 4.5x | 1.6% | 6.2% | - |
| | DCP MIDSTREAM PARTNERS LP | DPM | $30.75 | $29 | $32 | 7% | Market Perform / V | 10.0% | 1.3% | 8.5x | 7.8% | 8.0% | 4.0% |
| | WESTERN GAS PARTNERS LP | WES | $22.09 | $21 | $23 | 6% | Market Perform / V | 9.0% | 1.3% | 11.5x | 6.2% | 6.5% | 10.0% |
| | **Gathering & Processing MLP Median** | | | | | **19%** | | **10.0%** | **1.3%** | **9.5x** | **8.3%** | **7.8%** | **4.9%** |
| Upstream MLPs | ENCORE ENERGY PARTNERS LP | ENP | $17.59 | $21 | $23 | 37% | Outperform / V | 11.0% | 0.0% | 8.5x | 12.2% | 9.4% | (2.5%) |
| | LEGACY RESERVES LP | LGCY | $21.42 | $25 | $27 | 31% | Outperform / V | 11.0% | 0.0% | 9.5x | 9.7% | 8.2% | 2.3% |
| | VANGUARD NATURAL RESOURCES | VNR | $21.44 | $23 | $25 | 22% | Market Perform / V | 11.0% | 0.0% | 7.5x | 9.8% | 8.9% | 2.7% |
| | EV ENERGY PARTNERS LP | EVEP | $30.15 | $32 | $35 | 21% | Market Perform / V | 11.0% | 0.0% | 9.0x | 10.0% | 9.1% | 1.7% |
| | BREITBURN ENERGY PARTNERS LP | BBEP | $14.50 | $15 | $17 | 21% | Market Perform / V | 11.0% | 0.0% | 6.5x | - | 9.4% | - |
| | PIONEER SOUTHWEST ENERGY -LP | PSE | $22.10 | $23 | $25 | 18% | Market Perform / V | 11.0% | 0.0% | 10.5x | 9.0% | 8.3% | 1.8% |
| | LINN ENERGY LLC | LINE | $24.27 | $25 | $27 | 18% | Market Perform | 11.0% | 0.0% | 9.0x | 10.4% | 9.7% | 0.0% |
| | **Upstream MLP Median** | | | | | **21%** | | **11.0%** | **0.0%** | **9.0x** | **9.9%** | **9.1%** | **1.7%** |
| Propane | SUBURBAN PROPANE PRTNRS -LP | SPH | $44.21 | $54 | $57 | 33% | Outperform | 9.5% | 2.5% | 12.0x | 7.6% | 6.3% | 7.1% |
| | INERGY LP | NRGY | $35.13 | $39 | $41 | 22% | Outperform | 9.5% | 1.3% | 15.0x | 7.8% | 7.2% | 7.2% |
| | FERRELLGAS PARTNERS -LP | FGP | $22.06 | $21 | $22 | 7% | Market Perform / V | 10.5% | 1.3% | 10.0x | 9.1% | 9.3% | 1.6% |
| | AMERIGAS PARTNERS -LP | APU | $39.19 | $33 | $35 | (6%) | Underperform | 10.0% | 1.3% | 8.5x | 6.8% | 8.3% | 5.2% |
| | **Propane MLP Median** | | | | | **14%** | | **9.8%** | **1.3%** | **11.0x** | **7.7%** | **7.7%** | **6.2%** |
| Ship | TEEKAY OFFSHORE PARTNERS LP | TOO | $18.33 | $22 | $24 | 36% | Outperform / V | 10.0% | 1.3% | 10.0x | 9.8% | 8.2% | 4.5% |
| | TEEKAY LNG PARTNERS LP | TGP | $27.10 | $30 | $32 | 23% | Outperform / V | 9.5% | 1.3% | 11.5x | 8.4% | 7.7% | 4.6% |
| | K-SEA TRANSPORTATION -LP | KSP | $7.15 | $6 | $8 | (2%) | Underperform / V | 12.0% | 1.3% | 10.0x | - | - | - |
| | **Shipping MLP Median** | | | | | **23%** | | **10.0%** | **1.3%** | **10.0x** | **9.1%** | **8.0%** | **4.6%** |
| Coal | ALLIANCE RESOURCE PTNRS -LP | ARLP | $44.19 | $48 | $51 | 19% | Market Perform / V | 9.5% | 1.3% | 7.5x | 7.0% | 6.8% | 10.5% |
| | NATURAL RESOURCE PARTNERS LP | NRP | $21.31 | $22 | $24 | 18% | Underperform / V | 10.0% | 1.3% | 14.5x | 10.1% | 9.4% | 0.0% |
| | PENN VIRGINIA RES PRTNR LP | PVR | $20.99 | $21 | $22 | 11% | Market Perform / V | 10.0% | 1.3% | 9.5x | 9.0% | 8.7% | 1.7% |
| | **Coal MLP Median** | | | | | **18%** | | **10.0%** | **1.3%** | **9.5x** | **9.0%** | **8.7%** | **1.7%** |
| General Partnerships | ENERGY TRANSFER EQUITY LP | ETE | $31.72 | $38 | $41 | 31% | Outperform / V | 8.5% | 1.6% | 17.0x | 6.8% | 5.7% | 6.8% |
| | ALLIANCE HOLDINGS GP LP | AHGP | $28.62 | $33 | $35 | 26% | Market Perform / V | 9.5% | 1.8% | 17.0x | 6.3% | 6.0% | 14.9% |
| | NUSTAR GP HOLDINGS LLC | NSH | $27.44 | $30 | $33 | 21% | Outperform | 9.0% | 2.7% | 16.0x | 6.3% | 5.9% | 6.6% |
| | ENTERPRISE GP HOLDINGS LP | EPE | $43.19 | $46 | $50 | 16% | Outperform / V | 8.5% | 2.7% | 19.0x | 5.0% | 4.9% | 10.6% |
| | CROSSTEX ENERGY INC | XTXI | $7.82 | $8 | $10 | 16% | Market Perform / V | 11.0% | 3.8% | 19.0x | - | 4.4% | - |
| | BUCKEYE GP HOLDINGS LP | BGH | $30.25 | $32 | $34 | 15% | Market Perform / V | 8.5% | 2.6% | 19.5x | 5.4% | 5.3% | 9.2% |
| | PENN VIRGINIA GP HOLDINGS LP | PVG | $17.05 | $17 | $19 | 15% | Market Perform / V | 10.0% | 1.8% | 11.0x | 9.1% | 8.7% | 3.5% |
| | INERGY HOLDINGS LP | NRGP | $71.75 | $73 | $77 | 10% | Market Perform / V | 9.5% | 1.8% | 18.0x | 5.2% | 5.5% | 21.1% |
| | ATLAS PIPELINE HOLDINGS LP | AHD | $6.11 | $5 | $8 | 6% | Market Perform / V | 12.0% | 3.8% | 10.0x | - | - | - |
| | **General Partnership MLP Median** | | | | | **16%** | | **9.5%** | **2.6%** | **17.0x** | **6.3%** | **5.6%** | **9.2%** |
| | **All MLPs Average** | | | | | **19%** | | **9.6%** | **1.4%** | **11.8x** | **7.7%** | **7.3%** | **5.4%** |
| | **All MLPs Median** | | | | | **19%** | | **9.5%** | **1.3%** | **11.5x** | **7.8%** | **7.1%** | **4.6%** |

Note: Median yields exclude MLPs that have suspended their distributions

Source: FactSet, Standard & Poor's, and Wells Fargo Securities, LLC estimates

Date: 5/7/2010

## Valuation Range Information:

**AHD Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 12.0% and a long-term growth rate of 5.00%, and (2) a price-to-distributable cash flow multiple of about 10.0x our 2011 estimate. Risks to the stock trading in our range include a decline in commodity prices, the timing of a distribution reinstatement, and a decline in APL's gathering volume.

**AHGP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 9.5% and a long-term growth rate of 1.75%, and (2) a price-to-DCF multiple of about 17.0x our 2010 estimate. Risks to AHGP trading in the valuation range include (1) a decline in coal prices, (2) operational and regulatory risk related to development projects, and (3) rising interest rates.

**APL Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 12.0% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 7.5x our 2010 estimate. Risks to the stock trading in our range include a decline in commodity prices, the timing of a distribution reinstatement, and a decline in gathering volume.

**APU Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required ROR of 10.0% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 8.3x our 2010 estimate. Risks to APU trading in the valuation range include: (1) failure to identify and/or integrate attractive acquisitions; (2) unseasonably warm weather; (3) rising interest rates; and (4) profit margin erosion in response to higher energy prices.

**ARLP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 9.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 7.5x our 2010 estimate. Risks to ARLP trading below our valuation range include a decline in coal prices, operational risk, regulatory risk, delays in adding production, and higher interest rates.

**BBEP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage discounted free-cash flow model, which assumes a 11% required rate of return and a long-term growth rate of 0% and (2) a price-to-distributable cash flow multiple of about 6.5x our 2010 estimate. Risks to the units trading below our valuation range include a decline in commodity prices and the inability to hedge at favorable prices in future periods.

**BGH Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 2.6%, and (2) a price-to-distributable cash flow multiple of 19.5x our 2010 estimate. Risks to the units trading in our valuation range include a decline in demand for refined products, the inability to complete dropdown or third-party acquisitions to support growth, a potential for Buckeye to venture into higher risk businesses, and rising interest rates.

**BKEP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 10.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 13x our 2010 estimate. Risks to our valuation range include counterparty credit risk, lower crude oil and asphalt volumes, and rising interest rates.

**BPL Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.725%, and (2) a price-to-distributable cash flow multiple of about 12.5x our 2010E. Risks to the stock trading in our range include a weak economy, the inability to complete dropdown or third party acquisitions to support growth, a potential for Buckeye to venture into higher risk businesses, and rising interest rates.

**BWP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 13.0x our 2010 estimate. Risks to the units trading in our valuation range include securing special permits from the Dept. of Transportation to operate new pipeline projects at higher operating pressures (80% SYMS), recontracting pipeline capacity, execution of identified organic growth projects, and regulatory risk.

**CPNO Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 10.0% and a long-term growth rate of 2.5%, and (2) a price-to-distributable cash flow multiple of about 10x our 2010 estimate. Risks to the units trading below our valuation range include declining production, a decline in commodity prices, and rising interest rates.

**DEP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 2.5%, and (2) a price-to-DCF multiple of approximately 13x our 2010 estimate. Risks to DEP include dependence on EPD as a key customer and source of acquisitions, potential conflicts of interest, and rising interest rates.

**DPM Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 10.0% and a long-term growth rate of 1.25%, and (2) a price-to-DCF multiple of about 8.5x our 2010 estimate. Risks to the units trading in our range include the inability to find suitable investments, dependence on DCP Midstream for growth, supply risk, liquidity, and rising interest rates.

**EEP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.00%, and (2) a price-to-DCF multiple of about 11.5x our 2010 estimate. Risks to units trading in our valuation range include stagnant Canadian and U.S. drilling activity, execution risk on acquisitions and expansion projects, and offloading of volumes to competing pipelines.

**EEQ Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.00%, and (2) a price-to-distributable cash flow multiple of 11.5x our 2010 estimate. Risks to units trading in our valuation range include stagnant Canadian and U.S. drilling activity, execution risk on acquisitions and expansion projects.

**ENP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage discounted free-cash flow model, which assumes a 11% required rate of return and a long-term growth rate of 0%, and (2) a price-to-distributable cash flow multiple of about 8.5x our 2010 estimate. Risks to the units trading below our range include a dependence on acquisitions to fuel growth and partially offset the depletion of reserves, the inability to hedge at favorable prices, and rising interest rates.

**EPB Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 11.5x our 2010 estimate. Risks to the units trading below our valuation range include a slower-than-forecasted rate of dropdown acquisitions, re-contracting, and rising interest rates.

**EPD Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.875%, and (2) a price-to-DCF multiple of about 12.5x our 2010 estimate. Risks to EPD trading in our range include weakness in the petro-chem industry, low or negative frac spreads, and a decline or delay in deepwater GoM production.

**EPE Basis and Risks:** Our valuation range is based on a blend of (1) our distribution discount model that assumes a long-term growth rate of 2.7% and a 8.5% discount rate and (2) a price-to-DCF multiple of about 19.0x our 2010 estimate. Risks to EPE trading in the valuation range include (1) inability to identify attractive acquisition candidates or unsuccessful execution of an acquisition or an organic growth project; (2) potential conflicts of interest; (3) commodity price risk, particularly the price of NGLs and natural gas, due to its keepwhole and percentage of proceeds contracts; and (4) rising interest rates.

**EROC Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required ROR of 11.0% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 4.5x our 2010 estimate. Risks to the units trading below our valuation range include: success of proposed restructuring, growth dependent upon future acquisitions/investments, competitive Texas/Louisiana natural gas market and commodity price trends.

**ETE Basis and Risks:** Our range is based on a blend of (1) our distribution discount model, which assumes a long-term growth rate of 1.6%, and a 8.5% discount rate and (2) a price to distributable cash flow multiple of about 17.0x our 2010 estimate. Risks to ETE trading in the range include (1) unsuccessful execution of an acquisition or an organic growth project; (2) potential conflicts of interest; (3) competition in the Texas-Louisiana natural gas market; and (4) a decline in natural gas prices.

**ETP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 14.5x our 2010 estimate. Risks to ETP achieving our valuation range include: (1) execution risk related to integrating acquisitions and completing organic growth projects; (2) negative outcome from third-party litigation; (3) competition in the Texas-Louisiana natural gas market; and (4) abnormally warm weather.

**EVEP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage maximum potential distribution discount model, which assumes a required rate of return of 11% and a long-term growth rate of 0%, and (2) a price-to-distributable cash flow multiple of about 9x our 2010 estimate. Risks to the units trading below our valuation range include a sustained decline in natural gas prices, rising interest rates, and the dependence upon acquisitions to offset depletion and fuel growth.

**EXLP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 9.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 11x our 2010 estimate. Risks to the units trading below our valuation range include dependence on acquisitions to fuel growth, customer concentration, and rising interest rates.

**FGP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required ROR of 10.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 10.0x our 2010 estimate. Risks to FGP trading in our valuation range include: (1) abnormally warm weather; (2) profit margin erosion in response to volatility of energy prices; (4) lower volumes due to customer conservation and (3) rising interest rates.

**GEL Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required ROR of 9.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 11.8x our 2010 estimate. Risks to GEL trading in the valuation range include the integration of acquisitions, the fact that a significant part of GEL's operations is dependent on DNR's ability to supply oil and $CO_2$ volumes, competition for volumes of oil, natural gas and $CO_2$ and environmental risk inherent in gathering and transporting operations.

**HEP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required ROR of 9.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 13.0x our 2010 estimate. Risks to HEP units achieving our valuation range include: a material downturn in volumes flowing through HEP pipelines; increased competition in Southwestern markets; and the overall interest rate environment. Also, HOC and third party obligations under shipping agreements may be reduced or suspended under certain conditions such as the shutdown of one of its refineries.

**KGS Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required ROR of 9.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 10.3x our 2010 estimate. Risks to KGS not achieving our valuation range include the supply and demand fundamentals for natural gas and natural gas liquids, the availability of new sources of natural gas, accretive organic and acquired growth opportunities, customer and geographic concentration risk, and potential environmental liabilities.

**KMP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 14x our 2010 estimate. Risks to the units trading in our valuation range include (1) delays/cost overruns on expansion projects and (2) rising interest rates.

**KMR Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 14x our 2010 estimate. Risks to the units trading in our valuation range include (1) a final resolution to the SFPP rate case, (2) delays/cost overruns on expansion projects, and (3) rising interest rates.

**KSP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required ROR of 12.0% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 10.0x our 2010 estimate. Risks to KSP trading below the valuation range include competition in the marine vessel industry, a reduction in demand for petroleum products, potential debt covenant violations, possible environmental liabilities and any adverse change to marine transportation regulation.

**LGCY Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage discounted free cash flow model, which assumes a required rate of return of 11% and a long-term growth rate of 0%, and (2) a price-to-distributable cash flow multiple of about 9.5x our 2010 estimate. Risks to the units trading below our range include a sustained decline in crude oil prices and dependence upon acquisitions to fuel growth.

**LINE Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage discounted free-cash flow model, which assumes an 11% required rate of return and a long-term growth rate of 0%, and (2) a price-to-DCF multiple of about 9.0x our 2010 estimate. Risks to the units trading below our range include a dependence on acquisitions for growth, decreasing commodity prices, and the inability to hedge at favorable prices.

**MMLP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required ROR of 10.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 10.3x our 2010 estimate. Risks to MMLP achieving our valuation range include: weather influencing ocean and river conditions which could delay barge movements and interrupt terminal operations; volatility and lack of visibility for several of MMLP's business segments; the ability to integrate acquisitions; and interest rate sensitivity.

**MMP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 2.5%, and (2) a price-to-distributable cash flow multiple of about 15x our 2010 estimate. Risks to the units trading in our valuation range include the ability to identify and execute on organic projects, rising interest rates, and a slowing economy.

**MWE Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 10.0% and a long-term growth rate of 2.5%, and (2) a price-to-distributable cash flow multiple of about 10x our 2010 estimate. Risks to the units trading in our range include a decline in commodity prices, execution risk related to acquisitions, and rising interest rates.

**NGLS Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 10.0% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 9x our 2010 estimate. Risks to the units trading below our valuation range include a slower-than-forecasted rate of dropdown acquisitions, a decline in commodity prices, and rising interest rates.

**NRGP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required ROR of 9.5% and a long-term growth rate of 1.75%, and (2) a price-to-distributable cash flow multiple of 18.0x our 2010 estimate. Risks to NRGP trading below the valuation range include (1) failure of NRGY to identify and/or integrate acquisitions; (2) unseasonably warm weather; (3) profit margin erosion at NRGY due to higher energy prices; (4) stagnate new home construction; and (5) rising interest rates.

**NRGY Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required ROR of 10.0% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 14.8x our 2010 estimate. Risks to NRGY trading in the valuation range include (1) failure to identify and/or integrate attractive acquisitions; (2) unseasonably warm weather; (3) profit margin erosion in response to higher energy prices; (4) stagnate new home construction; and (5) rising interest rates.

**NRP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 10.0% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 14.5x our 2010 estimate. Risks to NRP trading in the valuation range include (1) a decline in coal prices, (2) delays in developing Cline reserves, and (3) a slowdown in acquisitions.

**NS Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 9.0% and a long-term growth rate of 1.875%, and (2) a price-to-distributable cash flow multiple of about 14.5x our 2010 estimate. Risks to the units trading in our valuation range include unplanned refinery turnarounds, regulatory, and rising interest rates.

**NSH Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 9.0% and a long-term growth rate of 2.7%, and (2) a price-to-distributable cash flow multiple of about 16x our 2010 estimate. Risks to the units trading in our valuation range include unplanned refinery turnarounds and rising interest rates.

**OKS Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.25%, and (2) a price-to-DCF multiple of about 13.5x our 2010 estimate. Risks to OKS units trading in our valuation range include (1) ability to re-contract pipeline capacity and (2) ability to mitigate commodity price risk via hedges.

**PAA Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 14.5x our 2010 estimate. Risks to PAA trading in our valuation range include potential losses from hedging activities, crude oil supply shortfalls, and rising interest rates.

**PSE Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage discounted free-cash flow model, which assumes a 11% required rate of return and a long-term growth rate of 0%, and (2) a price-to-distributable cash flow multiple of about 10.5x our 2010 estimate. Risks to the units trading below our range include a dependence on acquisitions to fuel growth, decreasing commodity prices, and rising interest rates.

**PVG Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 10.0% and a long-term growth rate of 1.75%, and (2) a price-to-distributable cash flow multiple of 11.0x our 2010 estimate. Risks to PVG trading in our valuation range include (1) a decline in commodity prices, (2) a slowdown in acquisitions, and (3) rising interest rates.

**PVR Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 10.0% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 9.25x our 2010 estimate. Risks to PVR trading in our valuation range include (1) a decline in commodity prices, (2) adverse political climate towards coal, (3) a slowdown in acquisitions, and (4) rising interest rates.

**RGNC Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 9.0% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 13x our 2010 estimate. Risks to the units trading below our valuation range include a slower-than-forecasted rate of dropdowns, a decline in commodity prices, and rising interest rates.

**SEP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 13.5x our 2010 estimate. Risks to the units trading below our valuation range include a slower than forecast rate of dropdown acquisitions, re-contracting, and rising interest rates.

**SPH Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required ROR of 9.5% and a long-term growth rate of 2.5%, and (2) a price-to-distributable cash flow multiple of 11.8x our 2010 estimate. Risks to SPH trading below our valuation range include: (1) abnormally warm weather; 2) economic weakness could negatively impact industrial/commercial demand; (3) profit margin erosion in response to energy prices; and (4) rising interest rates.

**SXL Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 8.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 12x our 2010 estimate. Risks to the units trading below our valuation range include customer concentration, refinery turnarounds, and rising interest rates.

**TCLP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required ROR of 10.0% and a long-term growth rate of 1.875%, and (2) a price-to-distributable cash flow multiple of 10.3x our 2010 estimate. Risks to TCLP trading in the valuation range include excess capacity on its pipeline systems, competitive industry conditions, economic trends, and environmental or regulatory risk.

**TGP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required ROR of 9.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 11.3x our 2010 estimate. Risks include a delay in the delivery of newbuilds, concentration of customers, lower-than-expected LNG demand, unforeseen drydocking cost and financial leverage.

**TLP Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required ROR of 9.5% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 9.8x our 2010 estimate. Risks to the stock trading in our valuation range include a weakening economy's impact on petroleum product demand and rising interest rates.

**TOO Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required ROR of 10.0% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of 10.0x our 2010 estimate. Primary risk to TOO achieving our valuation range include a decline in the rate of growth of demand for offshore vessels, dependence on Teekay Corporation to provide future financing, growth through acquisitions, regulatory issues, marine transportation risks and international risks.

**VNR Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a 11% required rate of return and a long-term 0% growth rate, and (2) a price-to-distributable cash flow multiple of about 7.5x our 2010 estimate. Risks to the units trading below our range include a decline in commodity prices, dependence upon acquisitions to fuel growth, and the inability to hedge at favorable prices.

**WES Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 9.0% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 11.5x our 2010 estimate. Risks to the units trading below our valuation range include a slower than forecast rate of dropdowns, customer concentration, and rising interest rates.

**WMZ Basis and Risks:** Our valuation range is based on a 0.7584 conversion ratio applied to our WPZ valuation range of $40-43/unit. Risks include approval of approval of Williams' restructuring plan, re-contracting pipeline capacity, an adverse regulatory environment, and rising interest rates.

**WPZ Basis and Risks:** Our valuation range is based on: (1) a three-stage distribution discount model assuming a 8.5% required rate of return and a 1.25% long-term growth rate and (2) a price-to-DCF multiple of about 10x our 2010 DCF per unit estimate. Risks to WPZ trading below our valuation range include approval of Williams' restructuring plan, sensitivity to commodity prices, an adverse regulatory environment, and rising interest rates.

**XTEX Basis and Risks:** Our valuation range is based on: (1) a three-stage distribution discount model assuming a 11% required rate of return and a 1.25% long-term growth rate and (2) a price-to-distributable cash flow multiple of about 6.0x our 2010 estimate. Risks to XTEX trading in our valuation range include: (1) execution risk related to improving liquidity and reducing leverage; (2) competition in the Texas-Louisiana natural gas market; (3) rising interest rates; and (4) lower processing margins.

**XTXI Basis and Risks:** Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 11.0% and a long-term growth rate of 3.80%, and (2) a price-to-distributable cash flow multiple of about 19.0x our 2011 estimate. Risks to XTXI trading in our valuation range include (1) execution risk related to XTEX improving liquidity and reducing leverage; (2) potential conflicts of interest; 3) competition in the Texas-Louisiana natural gas market; and 4) lower processing margins.

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- Atlas Pipeline Holdings, L.P., Atlas Pipeline Partners, L.P., Boardwalk Pipeline Partners, L.P., Buckeye GP Holdings L.P., Buckeye Partners, L.P., Copano Energy L.L.C., Crosstex Energy, Inc., Crosstex Energy, L.P., DCP Midstream Partners, L.P., Duncan Energy Partners, L.P., El Paso Pipeline Partners, L.P., Enbridge Energy Partners, L.P., Encore Energy Partners, L.P., Energy Transfer Equity, L.P., Energy Transfer Partners, L.P., Enterprise GP Holdings L.P., Enterprise Products Partners L.P., EV Energy Partners, L.P., Exterran Partners, L.P., Ferrellgas Partners, L.P., Genesis Energy, L.P., Inergy Holdings, L.P., Inergy, L.P., K-Sea Transportation Partners, L.P., Kinder Morgan Energy Partners, L.P., Kinder Morgan Management, LLC, Legacy Reserves, L.P., LINN Energy, LLC, Magellan Midstream Partners, L.P., MarkWest Energy Partners, L.P., Martin Midstream Partners, L.P., NuStar Energy, L.P., NuStar GP Holdings, LLC, ONEOK Partners, L.P., Penn Virginia GP Holdings, L.P., Penn Virginia Resource Partners, L.P., Pioneer Southwest Energy Partners, L.P., Plains All American Pipeline, L.P., Quicksilver Gas Services, L.P., Regency Energy Partners, L.P., Spectra Energy Partners, L.P., Suburban Propane Partners, L.P., Sunoco Logistics Partners L.P., Targa Resources Partners, L.P., TC Pipelines, L.P., Teekay LNG Partners, L.P., Teekay Offshore Partners, L.P., TransMontaigne Partners L.P., Vanguard Natural Resources, LLC, Western Gas Partners, L.P., Williams Partners L.P. currently is, or during the 12-month period preceding the date of distribution of the research report was, a client of Wells Fargo Securities, LLC. Wells Fargo Securities, LLC provided investment banking services to Atlas Pipeline Holdings, L.P., Atlas Pipeline Partners, L.P., Boardwalk Pipeline Partners, L.P., Buckeye GP Holdings L.P., Buckeye Partners, L.P., Copano Energy L.L.C., Crosstex Energy, Inc., Crosstex Energy, L.P., DCP Midstream Partners, L.P., Duncan Energy Partners, L.P., El Paso Pipeline Partners, L.P., Enbridge Energy Partners, L.P., Encore Energy Partners, L.P., Energy Transfer Equity, L.P., Energy Transfer Partners, L.P., Enterprise GP Holdings L.P., Enterprise Products Partners L.P., EV Energy Partners, L.P., Exterran Partners, L.P., Ferrellgas Partners, L.P., Genesis Energy, L.P., Inergy Holdings, L.P., Inergy, L.P., K-Sea Transportation Partners, L.P., Kinder Morgan Energy Partners, L.P., Kinder Morgan Management, LLC, Legacy Reserves, L.P., LINN Energy, LLC, Magellan Midstream Partners, L.P., MarkWest Energy Partners, L.P., Martin Midstream Partners, L.P., NuStar Energy, L.P., NuStar GP Holdings, LLC, ONEOK Partners, L.P., Penn Virginia GP Holdings, L.P., Penn Virginia Resource Partners, L.P., Pioneer Southwest Energy Partners, L.P., Plains All American Pipeline, L.P., Quicksilver Gas Services, L.P., Regency Energy Partners, L.P., Spectra Energy Partners, L.P., Suburban Propane Partners, L.P., Sunoco Logistics Partners L.P., Targa Resources Partners, L.P., TC Pipelines, L.P., Teekay LNG Partners, L.P., Teekay Offshore Partners, L.P., TransMontaigne Partners L.P., Vanguard Natural Resources, LLC, Western Gas Partners, L.P., Williams Partners L.P.
- Buckeye GP Holdings L.P., Buckeye Partners, L.P., EV Energy Partners, L.P., Magellan Midstream Partners, L.P., MarkWest Energy Partners, L.P., Plains All American Pipeline, L.P. currently is, or during the 12-month period preceding the date of distribution of the research report was, a client of Wells Fargo Securities, LLC. Wells Fargo Securities, LLC provided noninvestment banking securities-related services to Buckeye GP Holdings L.P., Buckeye Partners, L.P., EV Energy Partners, L.P., Magellan Midstream Partners, L.P., MarkWest Energy Partners, L.P., Plains All American Pipeline, L.P.
- Atlas Pipeline Holdings, L.P., Atlas Pipeline Partners, L.P., Ferrellgas Partners, L.P., Inergy Holdings, L.P., Inergy, L.P., MarkWest Energy Partners, L.P., Martin Midstream Partners, L.P., Regency Energy Partners, L.P., Suburban Propane Partners, L.P., Western Gas Partners, L.P. currently is, or during the 12-month period preceding the date of distribution of the research report was, a client of Wells Fargo Securities, LLC. Wells Fargo Securities, LLC provided nonsecurities services to Atlas Pipeline Holdings, L.P., Atlas Pipeline Partners, L.P., Ferrellgas Partners, L.P., Inergy Holdings, L.P., Inergy, L.P., MarkWest Energy Partners, L.P., Martin Midstream Partners, L.P., Regency Energy Partners, L.P., Suburban Propane Partners, L.P., Western Gas Partners, L.P.
- An affiliate of Wells Fargo Securities, LLC has received compensation for products and services other than investment banking services from Blueknight Energy Partners, L.P. in the past 12 months.
- Wells Fargo Securities, LLC received compensation for products or services other than investment banking services from Atlas Pipeline Holdings, L.P., Atlas Pipeline Partners, L.P., Buckeye GP Holdings L.P., Buckeye Partners, L.P., EV Energy Partners, L.P., Ferrellgas Partners, L.P., Inergy Holdings, L.P., Inergy, L.P., Magellan Midstream Partners, L.P., MarkWest Energy Partners, L.P., Martin Midstream Partners, L.P., Plains All American Pipeline, L.P., Regency Energy Partners, L.P., Suburban Propane Partners, L.P., Western Gas Partners, L.P. in the past 12 months.
- Wells Fargo Securities, LLC, is acting as financial advisor to Liberty Propane, L.P. in the announced sale of the company to Inergy Propane, LLC. Inergy Propane, LLC is a wholly owned subsidiary of Inergy, L.P.
- Wells Fargo Securities, LLC, is acting as financial advisor to Liberty Propane, L.P. in the announced sale of the company to Inergy Propane, LLC. Inergy Propane, LLC is an indirect subsidiary of Inergy Holdings, L.P.

**AHD:** Risks to the stock trading in our range include a decline in commodity prices, the timing of a distribution reinstatement, and a decline in APL's gathering volume.

**AHGP:** Risks to AHGP trading in the valuation range include (1) a decline in coal prices, (2) operational and regulatory risk related to development projects, and (3) rising interest rates.



**APL:** Risks to the stock trading in our range include a decline in commodity prices, the timing of a distribution reinstatement, and a decline in gathering volume.

**APU:** Risks to APU trading in the valuation range include: (1) failure to identify and/or integrate attractive acquisitions; (2) unseasonably warm weather; (3) rising interest rates; and (4) profit margin erosion in response to higher energy prices.

**ARLP:** Risks to ARLP trading below our valuation range include a decline in coal prices, operational risk, regulatory risk, delays in adding production, and higher interest rates.

**BBEP:** Risks to the units trading below our valuation range include a decline in commodity prices and the inability to hedge at favorable prices in future periods.

**BGH:** Risks to the units trading in our valuation range include a decline in demand for refined products, the inability to complete dropdown or third-party acquisitions to support growth, a potential for Buckeye to venture into higher risk businesses, and rising interest rates.

**BKEP:** Risks to our valuation range include counterparty credit risk, lower crude oil and asphalt volumes, and rising interest rates.

**BPL:** Risks to the stock trading in our range include a weak economy, the inability to complete dropdown or third party acquisitions to support growth, a potential for Buckeye to venture into higher risk businesses, and rising interest rates.

**BWP:** Risks to the units trading in our valuation range include securing special permits from the Dept. of Transportation to operate new pipeline projects at higher operating pressures (80% SYMS), recontracting pipeline capacity, execution of identified organic growth projects, and regulatory risk.

**CPNO:** Risks to the units trading below our valuation range include declining production, a decline in commodity prices, and rising interest rates.

**DEP:** Risks to DEP include dependence on EPD as a key customer and source of acquisitions, potential conflicts of interest, and rising interest rates.

**DPM:** Risks to the units trading in our range include the inability to find suitable investments, dependence on DCP Midstream for growth, supply risk, liquidity, and rising interest rates.

**EEP:** Risks to units trading in our valuation range include stagnant Canadian and U.S. drilling activity, execution risk on acquisitions and expansion projects, and offloading of volumes to competing pipelines.

**EEQ:** Risks to units trading in our valuation range include stagnant Canadian and U.S. drilling activity, execution risk on acquisitions and expansion projects.

**ENP:** Risks to the units trading below our range include a dependence on acquisitions to fuel growth and partially offset the depletion of reserves, the inability to hedge at favorable prices, and rising interest rates.

**EPB:** Risks to the units trading below our valuation range include a slower-than-forecasted rate of dropdown acquisitions, re-contracting, and rising interest rates.

**EPD:** Risks to EPD trading in our range include weakness in the petro-chem industry, low or negative frac spreads, and a decline or delay in deepwater GoM production.

**EPE:** Risks to EPE trading in the valuation range include (1) inability to identify attractive acquisition candidates or unsuccessful execution of an acquisition or an organic growth project; (2) potential conflicts of interest; (3) commodity price risk, particularly the price of NGLs and natural gas, due to its keepwhole and percentage of proceeds contracts; and (4) rising interest rates.

**EROC:** Risks to the units trading below our valuation range include: success of proposed restructuring, growth dependent upon future acquisitions/investments, competitive Texas/Louisiana natural gas market and commodity price trends.

**ETE:** Risks to ETE trading in the range include (1) unsuccessful execution of an acquisition or an organic growth project; (2) potential conflicts of interest; (3) competition in the Texas-Louisiana natural gas market; and (4) a decline in natural gas prices.

**ETP:** Risks to ETP achieving our valuation range include: (1) execution risk related to integrating acquisitions and completing organic growth projects; (2) negative outcome from third-party litigation; (3) competition in the Texas-Louisiana natural gas market; and (4) abnormally warm weather.

**EVEP:** Risks to the units trading below our valuation range include a sustained decline in natural gas prices, rising interest rates, and the dependence upon acquisitions to offset depletion and fuel growth.

**EXLP:** Risks to the units trading below our valuation range include dependence on acquisitions to fuel growth, customer concentration, and rising interest rates.

**FGP:** Risks to FGP trading in our valuation range include: (1) abnormally warm weather; (2) profit margin erosion in response to volatility of energy prices; (4) lower volumes due to customer conservation and (3) rising interest rates.

**GEL:** Risks to GEL trading in the valuation range include the integration of acquisitions, the fact that a significant part of GEL's operations is dependent on DNR's ability to supply oil and $CO_2$ volumes, competition for volumes of oil, natural gas and $CO_2$ and environmental risk inherent in gathering and transporting operations.

**HEP:** Risks to HEP units achieving our valuation range include: a material downturn in volumes flowing through HEP pipelines; increased competition in Southwestern markets; and the overall interest rate environment. Also, HOC and third party obligations under shipping agreements may be reduced or suspended under certain conditions such as the shutdown of one of its refineries.

**KGS:** Risks to KGS not achieving our valuation range include the supply and demand fundamentals for natural gas and natural gas liquids, the availability of new sources of natural gas, accretive organic and acquired growth opportunities, customer and geographic concentration risk, and potential environmental liabilities.

**KMP:** Risks to the units trading in our valuation range include (1) delays/cost overruns on expansion projects and (2) rising interest rates.

**KMR:** Risks to the units trading in our valuation range include (1) a final resolution to the SFPP rate case, (2) delays/cost overruns on expansion projects, and (3) rising interest rates.

**KSP:** Risks to KSP trading below the valuation range include competition in the marine vessel industry, a reduction in demand for petroleum products, potential debt covenant violations, possible environmental liabilities and any adverse change to marine transportation regulation.

**LGCY:** Risks to the units trading below our range include a sustained decline in crude oil prices and dependence upon acquisitions to fuel growth.

**LINE:** Risks to the units trading below our range include a dependence on acquisitions for growth, decreasing commodity prices, and the inability to hedge at favorable prices.

**MMLP:** Risks to MMLP achieving our valuation range include: weather influencing ocean and river conditions which could delay barge movements and interrupt terminal operations; volatility and lack of visibility for several of MMLP's business segments; the ability to integrate acquisitions; and interest rate sensitivity.



**MMP:** Risks to the units trading in our valuation range include the ability to identify and execute on organic projects, rising interest rates, and a slowing economy.

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## STOCK RATING

**1=Outperform**: The stock appears attractively valued, and we believe the stock's total return will exceed that of the market over the next 12 months. BUY
**2=Market Perform**: The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD
**3=Underperform**: The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

## SECTOR RATING

**O=Overweight**: Industry expected to outperform the relevant broad market benchmark over the next 12 months.
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**U=Underweight**: Industry expected to underperform the relevant broad market benchmark over the next 12 months.

## VOLATILITY RATING

**V** = A stock is defined as volatile if the stock price has fluctuated by +/-20% or greater in at least 8 of the past 24 months or if the analyst expects significant volatility. All IPO stocks are automatically rated volatile within the first 24 months of trading.

**As of: May 7, 2010**

| | |
|---|---|
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| 50% of companies covered by Wells Fargo Securities, LLC Equity Research are rated Market Perform. | Wells Fargo Securities, LLC has provided investment banking services for 41% of its Equity Research Market Perform-rated companies. |
| 5% of companies covered by Wells Fargo Securities, LLC Equity Research are rated Underperform. | Wells Fargo Securities, LLC has provided investment banking services for 46% of its Equity Research Underperform-rated companies. |

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May 7, 2010

*Equity Research*

# Janedis' Online Recruitment Update

**Postings Growth Trajectory Continues**

Media & Entertainment

- **Weekly look at global job postings:** This note summarizes our weekly job posting checks across markets and verticals. Postings growth for most of our samples is now in the double digits, as the employment environment appears to have stabilized. However, absolute volume of postings remains well below the levels seen in 2007-08, suggesting some lingering slack in employment. In light of lingering macro uncertainty and somewhat optimistic market expectations of a cyclical rebound, we remain cautious on both Monster (MWW, Market Perform, $16.62) and Dice (DHX, Market Perform, $8.43).
- **Monster.com postings growth off slightly versus last week:** Our sampling in top DMAs showed postings were up 18% yr/yr in the recent week (5/5) versus +19% for the previous week. Postings volume declined modestly versus last week. MTD postings are up 18% in May, versus +17% in April, +8% in March, -1% in February, and flat growth in January.
- **Dice.com postings growth remains at near 40%:** Dice.com postings were up 40% yr/yr in the recent week (5/6) versus +44% the previous week. MTD postings are up 40% in May, versus +35% in April, +14% in March, +5% in February, and -6% for January.
- **eFinancialCareers postings growth now more than 30%:** Postings growth was +32% yr/yr in the recent week (5/6), versus +28% the previous week. Key market trends include: U.S. +27% (+30% previous week), U.K. +55% (+52% previous week), France +28% (+10% previous week), and Germany off 14% (-16% previous week). MTD growth for May is 32%, versus +26% in April, +16% in March, +5% in February, and -8% in January.
- **Stepstone.com postings growth jumps to high teens:** For the recent week (5/05) postings were up 18% versus +12% in the previous week. Trends in key markets included: U.K. +12% (+1% previous week), Germany +39% (+31% previous week), and Belgium +23% (+19% previous week). May postings are up 18% MTD, versus +7% in April postings, -4% in March, -9% in February, and -17% in January.
- **Staffing firms posting growth moves higher:** Postings for our sample were up 25% yr/yr in the latest week (5/7), versus +23% the previous week. Robert Half was off 4% (+2% previous week), Manpower was +16% (+41% previous week), and Kelly was +93% (+63% previous week). MTD postings are up 25% in May versus +19% in April, +12% in March, +3% in February, and -7% in January.
- **Valuations already imply material improvement:** Monster and Dice are trading at 21.3x and 13.5x our 2010 (FY1) EV/EBITDA estimates, versus 2009 lows of about 2x and 3x, respectively. We think secular issues within online recruitment may offset the cyclical recovery that appears to be assumed by current valuation.


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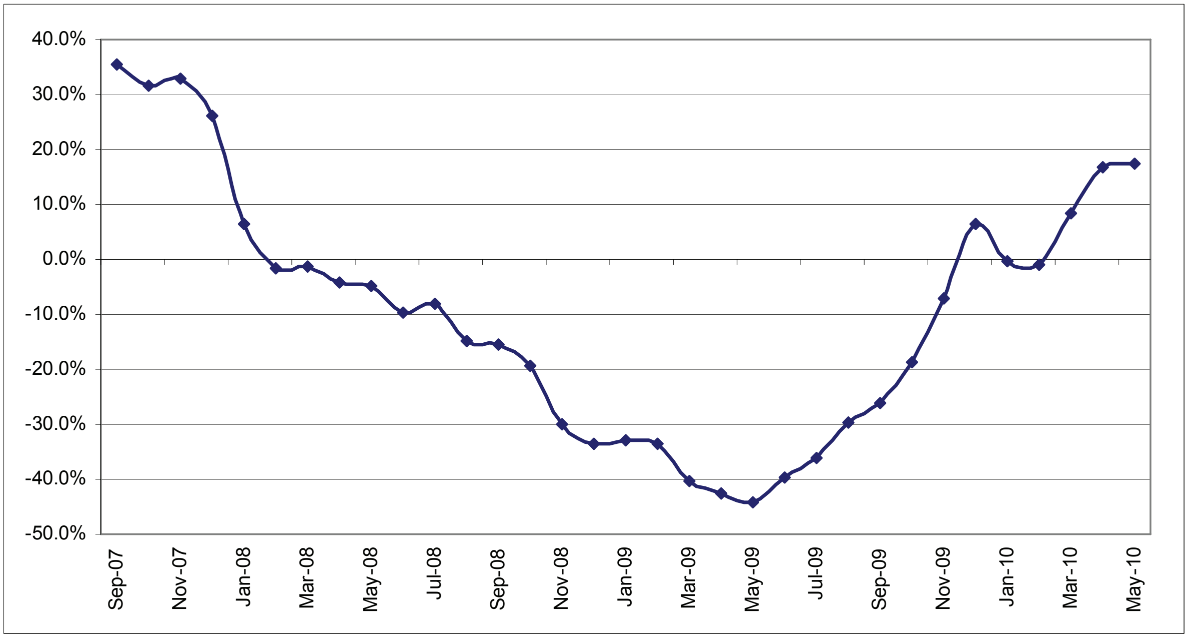
**Please see page 3 for rating definitions, important disclosures and required analyst certifications**

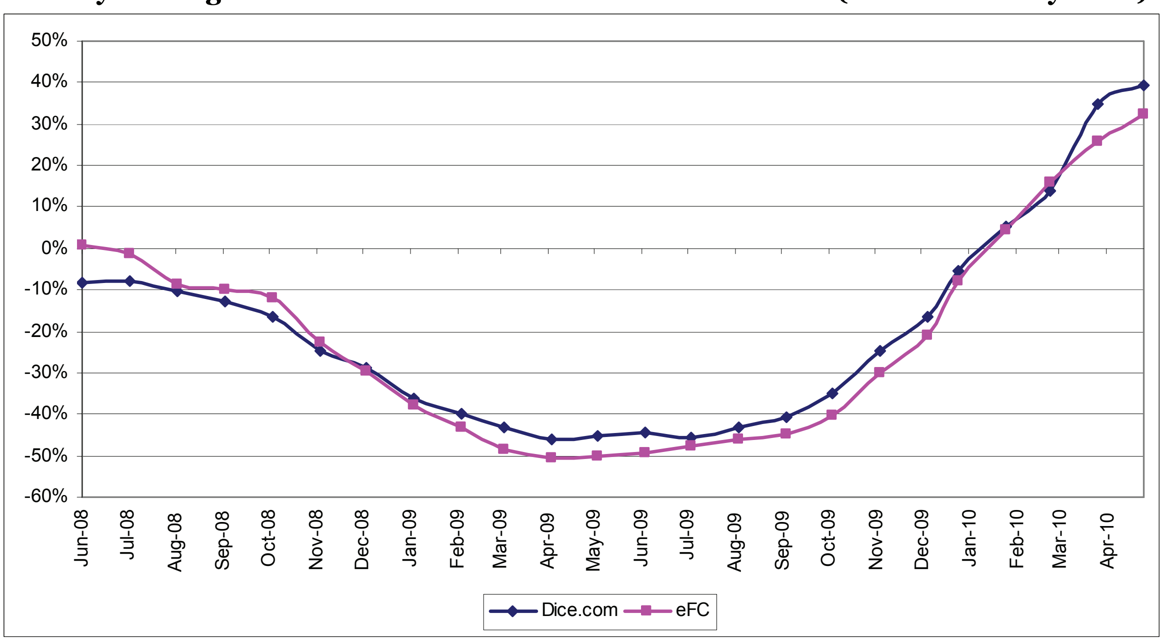
# Discussion

### Monthly Postings Growth Yr/Yr--Monster.com (September 2007-May 2010)



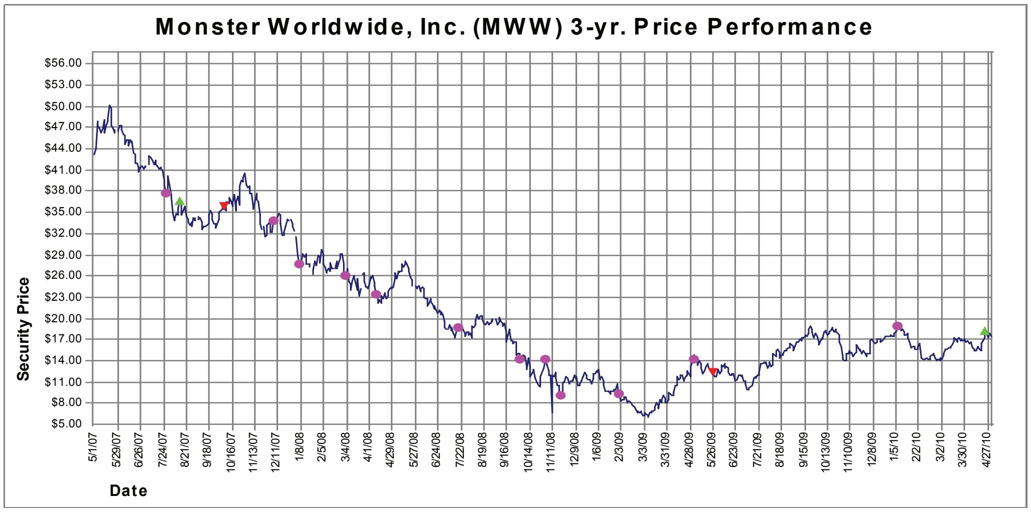

Source: Wells Fargo Securities, LLC estimates, Monster.com.

### Monthly Postings Data--Dice.com And efinancialcareers.com (June 2008-May 2010)




Source: Wells Fargo Securities, LLC estimates, Dice.com, efinancialcareers.com.

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 5/1/2007 | | Janedis | | | |
| | 5/1/2007 | NA | 2 | 46.00 | 48.00 | 43.21 |
| ● | 7/26/2007 | NA | 2 | 44.00 | 46.00 | 37.66 |
| ▲ | 8/13/2007 | NA | 1 | 44.00 | 46.00 | 36.65 |
| ▼ ● | 10/5/2007 | 35.81 | 2 | 39.00 | 41.00 | 35.86 |
| ● | 12/6/2007 | 33.90 | 2 | 37.00 | 39.00 | 33.90 |
| ● | 1/4/2008 | 28.93 | 2 | 30.00 | 32.00 | 27.73 |
| ● | 3/3/2008 | 26.59 | 2 | 26.00 | 28.00 | 26.07 |
| ● | 4/9/2008 | 23.48 | 2 | 24.00 | 26.00 | 23.48 |
| ● | 7/18/2008 | 18.80 | 2 | 19.00 | 21.00 | 18.60 |
| ● | 10/2/2008 | 15.03 | 2 | 15.00 | 17.00 | 14.15 |
| ● | 10/31/2008 | 12.87 | 2 | 15.00 | 16.00 | 14.24 |
| ● | 11/20/2008 | 9.23 | 2 | 9.00 | 10.00 | 9.02 |
| ● | 1/30/2009 | 10.46 | 2 | 8.00 | 9.00 | 9.21 |
| ● | 5/1/2009 | 13.80 | 2 | 13.00 | 15.00 | 14.16 |
| ▼ ● | 5/26/2009 | 12.45 | 3 | 9.00 | 10.00 | 12.38 |
| ● | 1/7/2010 | 18.60 | 3 | 13.00 | 15.00 | 18.85 |
| ▲ ● | 4/23/2010 | 17.31 | 2 | 15.00 | 16.00 | 18.25 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- □ Split Adjustment

**Rating Code Key**
- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate


| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| ❐ | 7/18/2007 | | IPO at $13.00 | | | |
| | 8/22/2007 | | Janedis | | | |
| ◆ | 8/22/2007 | NA | 1 | 11.00 | 12.00 | 9.83 |
| ● | 10/31/2007 | 12.59 | 1 | 13.00 | 13.50 | 12.81 |
| ● | 1/28/2008 | 6.80 | 1 | 10.00 | 11.00 | 6.70 |
| ● | 4/29/2008 | 7.05 | 1 | 8.00 | 9.00 | 6.95 |
| ▼ ● | 7/3/2008 | 7.99 | 2 | 7.00 | 8.00 | 7.35 |
| ● | 10/23/2008 | 3.57 | 2 | 4.00 | 4.50 | 3.57 |
| ● | 2/5/2009 | 2.88 | 2 | 2.00 | 2.50 | 2.95 |
| ● | 4/23/2009 | 4.02 | 2 | 3.50 | 4.00 | 3.90 |
| ● | 10/21/2009 | 6.64 | 2 | 6.00 | 7.00 | 6.77 |
| ● | 4/29/2010 | 9.03 | 2 | 8.00 | 9.00 | 9.31 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- ❐ Split Adjustment

**Rating Code Key**
- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

# Additional Information Available Upon Request

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- Wells Fargo Securities, LLC and/or its affiliates, have beneficial ownership of 1% or more of any class of the common stock of Monster Worldwide, Inc.

**DHX:** Risks include: 1) economic deceleration in the U.S. or Europe, 2) industry or vertical specific employment shocks.
**MWW:** Risks include: 1) a quicker, more robust improvement in employment and recruitment advertising, 2)a macro economic pullback, and 3) increased competition from emerging alternatives for online recruitment.

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**3=Underperform**: The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

## SECTOR RATING

**O=Overweight**: Industry expected to outperform the relevant broad market benchmark over the next 12 months.
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**As of: May 7, 2010**

| | |
|---|---|
| 45% of companies covered by Wells Fargo Securities, LLC Equity Research are rated Outperform. | Wells Fargo Securities, LLC has provided investment banking services for 37% of its Equity Research Outperform-rated companies. |
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| 5% of companies covered by Wells Fargo Securities, LLC Equity Research are rated Underperform. | Wells Fargo Securities, LLC has provided investment banking services for 42% of its Equity Research Underperform-rated companies. |

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SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE

May 7, 2010

WELLS FARGO SECURITIES

# *Equity Research*

## MetroPCS Communications Inc.

**PCS: Solid Sub Growth; But Remain Concerned LT**

**Market Perform / V**

Sector: Wireless Carriers
Market Weight

- PCS reported Q1 results. These results were characterized by extremely solid sub growth & better than expected churn. Revenues came in better, while EBITDA was lower mainly due to higher gross adds. We are adjusting our estimates to reflect stronger subscriber growth, lower ARPU and lower churn than modeled. Our new '10 revenue, EBITDA and EPS estimates are $4.0B, $1.06B and $0.44 versus our prior estimates of $4.0B, $1.14B and $0.55. Our new '11 revenue, EBITDA and EPS estimates are $4.5B, $1.3B and $0.72 versus our prior estimates of $4.4B, $1.3B and $0.72. We are raising our net add number for 2010 from 837k to 1.24MM. While PCS's Q1 results were clearly impressive and we were encouraged that the new Sprint pricing plans did not lower the bar for unlimited price points, we remain on the sidelines here as we continue to be cautious as to how the overall promotional environment in the prepay space near term could impact PCS's share of gross adds near term. We are raising our valuation range from $6.50 - $7.50 to $8.00 - $8.50. **We maintain our Market Perform (2) rating on the shares.**
- **SUBSCRIBER GROWTH SIGNIFICANTLY BETTER THAN EXPECTED; SOLID START TO 2010** - Gross adds in the quarter were 1.47M versus our estimate of 1.43M. Net adds were much better than modeled at 691k vs our estimate of 418k and street consensus of 382k. While PCS does not break out results between legacy and Northeast any more, management indicated it is still "gaining traction" in the Northeast and saw solid results in legacy.
- **NEW SPRINT PLANS MAY NOT BE AS APPEALING TO PCS USERS GIVEN MOU TRENDS** - When asked about risk from the newly introduced Sprint plans - management indicated the average minutes of use (MOU) of its base would indicate that its customer base favors the unlimited model. Put another way, the new plans outlined by Virgin Mobile / S this morning likely will not be attractive to PCS's base, in management's view, as the unlimited voice option is still $20 above PCS's $40 plan.
- **LIMITED GUIDANCE BUT DO EXPECT TYPICAL SEASONALITY OF CHURN & SUB GROWTH** - While the company did not give forward looking guidance, it did indicate it expects lower adds and higher churn in the summer months. Despite this, PCS's CEO indicated it is "pleased so far with the momentum" seen going into this time period.

### *Earnings Estimate Revised Down*

| EBITDA | 2009A | 2010E Curr. | 2010E Prior | 2011E Curr. | 2011E Prior |
|---|---|---|---|---|---|
| **Q1** (Mar.) | $0.56 | **$0.63 A** | **0.66** | **$0.83** | **0.81** |
| **Q2** (June) | 0.65 | **0.77** | **0.83** | **0.94** | **0.85** |
| **Q3** (Sep.) | 0.77 | **0.82** | **0.87** | **0.96** | **0.93** |
| **Q4** (Dec.) | 0.71 | **0.76** | **0.84** | **0.85** | **0.95** |
| **FY** | $2.69 | **$2.98** | **3.19** | **$3.57** | **3.55** |
| **CY** | $2.69 | $2.98 | | $3.57 | |
| **FY P/EBITDA** | 3.0x | 2.7x | | 2.3x | |
| **Rev.(MM)** | $3,481 | $4,021 | | $4,464 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

| | |
|---|---|
| Ticker | PCS |
| Price (05/06/2010) | $8.06 |
| 52-Week Range: | $5-19 |
| Shares Outstanding: (MM) | 356.6 |
| Market Cap.: (MM) | $2,874.2 |
| S&P 500: | 1,128.15 |
| Avg. Daily Vol.: | 6,231,160 |
| Dividend/Yield: | $0.00/0.0% |
| LT Debt: (MM) | $3,608.0 |
| LT Debt/Total Cap.: | 97.7% |
| ROE: | 33.0% |
| 3-5 Yr. Est. Growth Rate: | 25.0% |
| CY 2010 Est. P/EBITDA-to-Growth: | 0.1x |
| Last Reporting Date: | 05/06/2010 Before Open |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

**Valuation Range: $8.00 to $8.50** **from $6.50 to $7.50**
Our valuation range is based on a 5.0x-5.2x 2010E EV/EBITDA multiple. Risks to our range include increasing competition from larger carriers, higher churn associated with the company's customer base, and potential market launch delays.

**Investment Thesis:**
We continue to believe PCS faces many headwinds beyond its immediate control - namely driven by the changing competitive landscape and pricing approach around the prepay space. As a result, we struggle with catalysts to driver further multiple expansion.

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**Please see page 5 for rating definitions, important disclosures and required analyst certifications**

**Company Description:**

Based in Dallas, Texas, Metro PCS offers a unique, low-cost alternative wireless communications solution to the credit-challenged segment--which is currently somewhat underserved by the national wireless carriers. Specifically, PCS offers a no contract, pay-in-advance unlimited local calling product at price points between $30-$50/month. The company originally launched service back in 2002 with operations in the Miami, Atlanta, Sacramento, and San Francisco metropolitan areas. PCS is currently in the process of rapidly expanding its footprint and currently owns spectrum licenses covering approximately 140MM POPs in the U.S.--which include 14 of the top 25 largest metropolitan areas in the country. All in, the company intends to expand to roughly 95MM POPs--representing almost a 150% increase in the company's footprint from year-end 2006.

## Q1 2010 EARNINGS

PCS reported Q1 results. These results were characterized by extremely solid sub growth & better than expected churn. Revenues came in better, while EBITDA was lower mainly due to higher gross adds. The table below outlines the company's actual results vs. our estimates and those of the year ago period.

**SUMMARY OF ESTIMATES**

| ($ in millions) | Q1 '10A | Q1 '10E | Q1 '09A | Y/Y% |
|---|---|---|---|---|
| Service Revenue | 853.3 | 861.5 | 766.9 | 11.3% |
| Total Revenue | 970.5 | 974.5 | 859.6 | 12.9% |
| Adjusted EBITDA | 223.6 | 233.8 | 233.8 | -4.4% |
| Adjusted EBITDA Margin | 26.2% | 27.1% | 30.5% | |
| Adjusted EPS | $0.06 | $0.07 | $0.07 | -12.7% |
| | | | | |
| Operational Statistics | | | | |
| Subscriber Gross Additions ('000) | 1,471 | 1,433 | 1,289 | 14.1% |
| Subscriber Net Additions ('000) | 692 | 418 | 206 | 236.4% |
| CPGA | $146.18 | $157.82 | $159.87 | -8.6% |
| CPU | $18.79 | $17.40 | $16.82 | 11.7% |
| Churn | 3.7% | 5.1% | 5.8% | |
| Average Revenue Per User (ARPU) | $39.79 | $39.79 | $40.52 | -1.8% |

Source: Wells Fargo Securities, LLC estimates and company reports

**Q1 REVENUE & EBITDA** – PCS reported Q1 revenue and EBITDA of $971M and $224M versus our estimates of $975M and $234M. Handset subsidies from better than modeled gross adds (see below) drove the EBITDA shortfall while ARPU was inline at $39.83 vs our $39.79.

**SUBSCRIBER GROWTH SIGNIFICANTLY BETTER THAN EXPECTED; SOLID START TO 2010 -** Gross adds in the quarter were 1.47M versus our estimate of 1.43M. Net adds were much better than modeled at 691k vs our estimate of 418k and street consensus of 382k. While PCS does not break out results between legacy and Northeast any more, management indicated it is still "gaining traction" in the Northeast and saw solid results in legacy.

**CHURN IMPROVEMENT ALSO IMPRESSIVE** Churn was 3.7% vs our estimate of 5.1% and slightly better gross adds drove the better than expected net adds. Management credited churn improvement to a combination of factors. A large part of this was the simplicity of the "*Wireless for All*" new price plans (no taxes, extra fees, allows for less 'sticker shock'). PCS indicated it has seen continued improvement in churn throughout the year thus far. But acknowledged there is, and likely will be, seasonality in this metric.

**LTE PLANS ON TRACK** – Management reiterated its plans for LTE for later this year. It has completed test calls in both Seattle and Dallas. While PCS will not break out the capx it plans to spend on LTE, it did indicate the additional op-x associated with LTE was mostly centered around backhaul.

**NEW SPRINT PLANS MAY NOT BE AS APPEALING TO PCS USERS GIVEN MOU TRENDS -** When asked about risk from the newly introduced Sprint plans - management indicated the average minutes of use (MOU) of its base would indicate that its customer base favors the unlimited model. Put another way, the new plans outlined by Virgin Mobile / S this morning likely will not be attractive to PCS's base, in management's view, as the unlimited voice option is still $20 above PCS's $40 plan.

**FINANCIAL OUTLOOK**

**LIMITED GUIDANCE BUT DO EXPECT TYPICAL SEASONALITY OF CHURN & SUB GROWTH -** While the company did not give forward looking guidance, it did indicate it expects lower adds and higher churn in the summer months. Despite this, PCS's CEO indicated it is "pleased so far with the momentum" seen going into this time period.

**FINANCIAL OUTLOOK** – We are adjusting our estimates to reflect stronger subscriber growth, lower ARPU and lower churn than modeled. Our new '10 revenue, EBITDA and EPS estimates are $4.0B, $1.06B and $0.44 versus our prior estimates of $4.0B, $1.14B and $0.55. Our new '11 revenue, EBITDA and EPS estimates are $4.5B, $1.3B and $0.72 versus our prior estimates of $4.4B, $1.3B and $0.72. We are raising our net add number for 2010 from 837k to 1.24MM. Most of this change is due to the significant beat in Q1. We note management mentioned on the call that Q1 in 2010 could represent a larger percentage of net adds for the year than in past years. As a frame of reference, in 2009 Q1 accounted for 54% of total 2009 net adds.

| **SUMMARY OF ESTIMATE CHANGES** | **Q2 '10E** | | **2010E** | | **2011E** | |
|---|---|---|---|---|---|---|
| **($ in millions)** | **NEW** | **OLD** | **NEW** | **OLD** | **NEW** | **OLD** |
| Service Revenue | 891.5 | 892.2 | 3,567.4 | 3,597.2 | 3,971.2 | 3,922.7 |
| Total Revenue | 1,002.6 | 996.9 | 4,020.9 | 4,032.6 | 4,463.7 | 4,418.4 |
| Adjusted EBITDA | 273.5 | 293.8 | 1,060.8 | 1,135.4 | 1,283.4 | 1,277.3 |
| Adjusted EBITDA Margin | 30.7% | 32.9% | 29.7% | 31.6% | 32.3% | 32.6% |
| Adjusted Diluted EPS | $0.12 | $0.16 | $0.44 | $0.55 | $0.72 | $0.72 |
| Operational Statistics | | | | | | |
| Subscriber Gross Additions ('000) | 1,160 | 1,196 | 4,943 | 5,154 | 4,943 | 5,334 |
| Subscriber Net Additions ('000) | 170 | 95 | 1,240 | 837 | 770 | 890 |
| Churn | 4.5% | 5.2% | 4.2% | 5.1% | 4.2% | 4.7% |
| Average Revenue Per User (ARPU) | $38.90 | $39.71 | $39.09 | $39.91 | $38.21 | $38.79 |

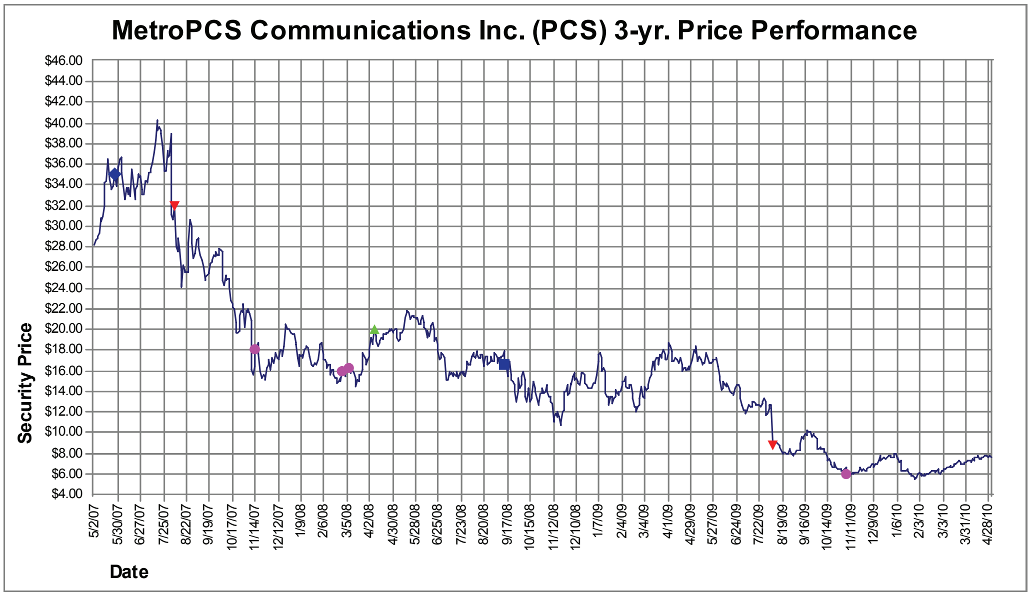
Source: Wells Fargo Securities, LLC estimates

MetroPCS Communications Inc.
($ in millions)

| INCOME STATEMENT | 2008 | 1Q09 | 2Q09 | 3Q09 | 4Q09 | 2009 | 1Q10 | 2Q10E | 3Q10E | 4Q10E | 2010E | 2011E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Service revenue | **2,437.3** | 726.7 | 766.9 | 812.3 | 824.5 | **3,130.4** | 853.3 | 891.5 | 904.1 | 918.5 | **3,567.4** | **3,971.2** |
| *y/y growth %* | *27.0%* | *29.3%* | *28.1%* | *33.0%* | *23.8%* | *28.4%* | *17.4%* | *16.3%* | *11.3%* | *11.4%* | *14.0%* | *11.3%* |
| *seq. growth %* | | *9.1%* | *5.5%* | *5.9%* | *1.5%* | | *3.5%* | *4.5%* | *1.4%* | *1.6%* | | |
| Equipment revenue | **314.3** | 68.6 | 92.8 | 83.3 | 105.5 | **350.1** | 117.2 | 111.1 | 105.6 | 119.6 | **453.5** | **492.5** |
| *y/y growth %* | *-0.7%* | *-31.0%* | *15.0%* | *9.5%* | *83.1%* | *11.4%* | *70.8%* | *19.7%* | *26.9%* | *13.4%* | *29.5%* | *8.6%* |
| **Total revenue** | **2,751.5** | **795.3** | **859.6** | **895.6** | **930.0** | **3,480.5** | **970.5** | **1,002.6** | **1,009.8** | **1,038.0** | **4,020.9** | **4,463.7** |
| *y/y growth %* | *23.1%* | *20.1%* | *26.0%* | *30.4%* | *28.5%* | *26.5%* | *22.0%* | *16.6%* | *12.7%* | *11.6%* | *15.5%* | *11.0%* |
| Cost of service | **857.3** | 245.6 | 268.7 | 298.3 | 307.5 | **1,120.1** | 284.7 | 290.3 | 296.2 | 302.1 | **1,173.2** | **1,269.9** |
| *Service gross margin %* | *64.8%* | *66.2%* | *65.0%* | *63.3%* | *62.7%* | *64.2%* | *66.6%* | *67.4%* | *67.2%* | *67.1%* | *67.1%* | *68.0%* |
| Cost of equipment | **704.6** | 225.0 | 227.4 | 199.1 | 232.8 | **884.3** | 313.7 | 286.9 | 268.5 | 311.9 | **1,181.1** | **1,265.3** |
| *Equipment gross margin %* | *-124.2%* | *-227.9%* | *-145.1%* | *-139.1%* | *-120.7%* | *-152.6%* | *-167.6%* | *-158.4%* | *-154.2%* | *-160.9%* | *-160.5%* | *-156.9%* |
| Selling expenses | 212.3 | 74.9 | 74.3 | 73.0 | 80.1 | 302.3 | 89.1 | 89.8 | 90.2 | 90.7 | 359.9 | 367.6 |
| *Selling % of service revenue* | *8.7%* | *10.3%* | *9.7%* | *9.0%* | *9.7%* | *9.7%* | *10.4%* | *10.1%* | *10.0%* | *9.9%* | *10.1%* | *9.3%* |
| G&A | 235.3 | 61.5 | 68.0 | 65.5 | 70.4 | 265.5 | 70.8 | 74.0 | 73.2 | 75.3 | 293.3 | 325.6 |
| *G&A % of service revenue* | *9.7%* | *8.5%* | *8.9%* | *8.1%* | *8.5%* | *8.5%* | *8.3%* | *8.3%* | *8.1%* | *8.2%* | *8.2%* | *8.2%* |
| SG&A (ex. D&A) | **447.6** | 136.4 | 142.3 | 138.5 | 150.5 | **567.7** | 159.9 | 163.8 | 163.5 | 166.0 | **653.2** | **693.2** |
| *SG&A % of service revenue* | *18.4%* | *18.8%* | *18.6%* | *17.0%* | *18.3%* | *18.1%* | *18.7%* | *18.4%* | *18.1%* | *18.1%* | *18.3%* | *17.5%* |
| EBITDA | **742.0** | 188.3 | 221.2 | 259.8 | 239.2 | **908.5** | 212.2 | 261.5 | 281.7 | 258.0 | **1,013.4** | **1,235.4** |
| Plus: Stock-based compensation | **41.1** | 10.7 | 12.7 | 12.4 | 12.0 | **47.8** | 11.4 | 12.0 | 12.0 | 12.0 | **47.4** | **48.0** |
| **Adjusted EBITDA** | **783.1** | **199.0** | **233.8** | **272.2** | **251.2** | **956.2** | **223.6** | **273.5** | **293.7** | **270.0** | **1,060.8** | **1,283.4** |
| *Adjusted EBITDA Margin %* | *32.1%* | *27.4%* | *30.5%* | *33.5%* | *30.5%* | *30.5%* | *26.2%* | *30.7%* | *32.5%* | *29.4%* | *29.7%* | *32.3%* |
| *y/y growth %* | *17.4%* | *11.9%* | *11.3%* | *35.5%* | *29.3%* | *22.1%* | *12.4%* | *17.0%* | *7.9%* | *7.5%* | *10.9%* | *21.0%* |
| Depreciation and amortization | **255.3** | 81.7 | 91.4 | 99.0 | 105.8 | **377.9** | 107.8 | 118.6 | 123.0 | 128.6 | **477.9** | **535.2** |
| *D&A % of service revenue* | *10.5%* | *11.2%* | *11.9%* | *12.2%* | *12.8%* | *12.1%* | *12.6%* | *13.3%* | *13.6%* | *14.0%* | *13.4%* | *13.5%* |
| Loss (gain) on disposal of assets | **18.9** | (24.9) | 14.0 | 2.6 | 3.6 | **(4.7)** | (0.8) | 1.0 | 1.0 | 1.0 | **2.2** | **4.0** |
| Operating income | **467.8** | 131.5 | 115.8 | 158.2 | 129.8 | **535.3** | 105.2 | 141.9 | 157.7 | 128.4 | **533.3** | **696.2** |
| *Operating margin %* | *17.0%* | *16.5%* | *13.5%* | *17.7%* | *14.0%* | *15.4%* | *10.8%* | *14.2%* | *15.6%* | *12.4%* | *13.3%* | *15.6%* |
| Interest expense | **179.4** | 58.4 | 70.5 | 70.4 | 70.9 | **270.3** | 67.5 | 70.5 | 70.5 | 70.5 | **279.0** | **282.0** |
| Accretion of put option in majority-owned sub | **1.3** | 0.4 | 0.4 | 0.4 | 0.4 | **1.6** | 0.5 | 0.4 | 0.4 | 0.4 | **1.7** | **1.6** |
| Interest and other income | **(23.2)** | (0.6) | (0.5) | (0.9) | (0.7) | **(2.6)** | (0.5) | (0.9) | (1.8) | (2.1) | **(5.3)** | **(6.4)** |
| Impairment loss on investment securities | **30.9** | 0.9 | 0.5 | 0.4 | 0.6 | **2.4** | 0.0 | 0.5 | 0.5 | 0.5 | **1.5** | **2.0** |
| Pre-tax income | **279.4** | 72.3 | 44.8 | 87.9 | 58.7 | **263.7** | 37.8 | 71.5 | 88.1 | 59.1 | **256.4** | **416.9** |
| Income taxes | **(130.0)** | (28.3) | (18.6) | (14.4) | (25.6) | **(86.8)** | (15.1) | (27.2) | (33.5) | (22.5) | **(98.2)** | **(158.4)** |
| Effective tax rate % | 46.5% | 39.2% | 41.5% | 16.3% | 43.6% | 32.9% | 40.0% | 38.0% | 38.0% | 38.0% | 38.3% | 38.0% |
| Net income to common | **149.4** | 44.0 | 26.2 | 73.6 | 33.1 | **176.8** | 22.7 | 44.3 | 54.6 | 36.6 | **158.2** | **258.5** |
| Comprehensive income | **131.4** | 43.6 | 26.2 | 73.6 | 33.1 | **176.5** | 29.4 | 44.3 | 54.6 | 36.6 | **165.0** | **258.5** |
| **Diluted EPS** | **$0.42** | **$0.12** | **$0.07** | **$0.21** | **$0.09** | **$0.50** | **$0.06** | **$0.12** | **$0.15** | **$0.10** | **$0.44** | **$0.72** |
| **EBITDA / Share** | **$2.20** | **$0.56** | **$0.65** | **$0.77** | **$0.71** | **$2.69** | **$0.63** | **$0.77** | **$0.82** | **$0.76** | **$2.98** | **$3.57** |
| Diluted shares | **355.4** | 356.4 | 357.1 | 355.4 | 353.7 | **355.6** | 354.0 | 355.0 | 356.0 | 357.0 | **355.5** | **359.5** |

Source: Wells Fargo Securities, LLC estimates and company reports

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 5/25/2007 | | Powell | | | |
| ◆ | 5/25/2007 | 35.01 | 1 | 39.00 | 42.00 | 35.01 |
| ▼● | 8/7/2007 | 32.00 | 2 | 30.00 | 34.00 | 32.00 |
| ● | 11/14/2007 | 18.05 | 2 | 18.00 | 20.00 | 18.13 |
| ● | 2/28/2008 | 15.00 | 2 | 14.00 | 16.00 | 15.90 |
| ● | 3/7/2008 | 16.20 | 2 | 17.00 | 19.00 | 16.20 |
| ▲● | 4/8/2008 | 18.89 | 1 | 22.00 | 25.00 | 20.00 |
| ■ | 9/15/2008 | | Fritzsche | | | |
| ▼● | 8/7/2009 | 8.99 | 2 | 9.00 | 9.50 | 8.74 |
| ● | 11/5/2009 | 6.01 | 2 | 6.50 | 7.50 | 6.01 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- □ Split Adjustment

**Rating Code Key**
- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

## Additional Information Available Upon Request

I certify that:
1) All views expressed in this research report accurately reflect my personal views about any and all of the subject securities or issuers discussed; and
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**PCS:** Risks to our range include increasing competition from larger carriers, higher churn associated with the company's customer base, and potential market launch delays.

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**2=Market Perform:** The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD
**3=Underperform:** The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

## SECTOR RATING

**O=Overweight:** Industry expected to outperform the relevant broad market benchmark over the next 12 months.
**M=Market Weight:** Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.
**U=Underweight:** Industry expected to underperform the relevant broad market benchmark over the next 12 months.

## VOLATILITY RATING

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As of: May 7, 2010

| | |
|---|---|
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SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE

May 7, 2010

# Equity Research

## PartnerRe Ltd.

**PRE: Conference Call Round-Up**

**Outperform**

Sector: Property & Casualty Insurance
Market Weight

- **SUMMARY:** PartnerRe hosted its Q1 2009 earnings conference call today. Key issues addressed included market conditions, PARIS RE integration and details on the Deepwater Horizon rig loss. We are adjusting our 2010 and 2011 EPS estimates to $6.40 and $10.20 (from $6.87 and $10.30, respectively) to reflect higher interest expense and rig losses, partially offset by higher share repurchase. The PRE shares should be largely unchanged following the call.
- PRE described the current market environment as "acceptable, although not great". Management does not see a near-term catalyst in either the reinsurance or capital markets that would improve trends. Overall, PRE expects the reinsurance industry's profitability levels to remain in the high single digits.
- Management did point to some select pockets of opportunity. In its non-life book, PRE could benefit from higher rates in Latin American, mainly on facultative business and in energy and marine lines, following the recent losses.
- PRE expects its life business to become a bigger contributor to premiums over the next few years. The company is seeing more longevity reinsurance deals, particularly in the UK and increased demand on the mortality side from European life insurers seeking capital relief prior to Solvency II.
- As it had expected PRE saw about a 20% reduction in PARIS RE premiums during both the January and April 1 renewals (after adjusting for the business that moved over to PartnerRe paper). About half the decline was due to client preference and the other half to PRE's decision to nonrenew.
- Last week, PRE provided an initial estimate for the Deepwater Horizon rig loss of $60-70MM pre-tax (or $0.64-0.75/sh after tax) based on a $1B loss estimate.
- Despite new reports of an industry loss estimate as high as $3.5 billion, PRE sees no reason to revise its own loss estimates. Two thirds of its exposure is capped by retro coverage. In a 'worst case' PRE could see additional $10-20 million of losses for its PARIS RE treaty book, which is not covered by retro.
- Mr. Thiele commented on his pending retirement. He noted the announcement was not a surprise to the Board, just a normal transition following his ten years as CEO, and that a succession plan has been in place for three years.
- PRE has no exposure to the sovereign debt of the PIIGS (Portugal, Ireland, Italy, Greece, and Spain) countries. All remaining holdings of this type of government bond were sold in mid January.

### *Earnings Estimate Revised Down*

| | 2009A | 2010E | | 2011E | |
|---|---|---|---|---|---|
| **EPS** | | **Curr.** | **Prior** | **Curr.** | **Prior** |
| **Q1** (Mar.) | $2.72 | ($0.50) A | NC | **$2.70** | **2.71** |
| **Q2** (June) | 3.12 | **2.00** | **2.37** | **2.42** | **2.45** |
| **Q3** (Sep.) | 4.77 | **2.42** | **2.44** | **2.51** | **2.56** |
| **Q4** (Dec.) | 3.87 | **2.51** | **2.54** | **2.57** | **2.58** |
| **FY** | $14.59 | **$6.40** | **6.87** | **$10.20** | **10.30** |
| **CY** | $14.59 | $6.40 | | $10.20 | |
| **FY P/E** | 5.0x | 11.4x | | 7.2x | |
| **Rev.(MM)** | $3,949 | $4,926 | | $5,005 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

*[d]EPS represents operating EPS. Revenue represents NPW. 2009 Qs do not sum due to a change in the share count..*

| | |
|---|---|
| Ticker | PRE |
| Price (05/07/2010) | $73.18 |
| 52-Week Range: | $61-82 |
| Shares Outstanding: (MM) | 82.6 |
| Market Cap.: (MM) | $6,044.7 |
| S&P 500: | 1,120.79 |
| Avg. Daily Vol.: | 797,766 |
| Dividend/Yield: | $2.00/2.7% |
| LT Debt: (MM) | $750.0 |
| LT Debt/Total Cap.: | 9.2% |
| ROE: | NM |
| 3-5 Yr. Est. Growth Rate: | 10.0% |
| CY 2010 Est. P/E-to-Growth: | 1.1x |
| Last Reporting Date: | 05/06/2010 After Close |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

*ROE is for the Q1 2010 annualized.*

### Valuation Range: $86.00 to $92.00

Our valuation range of $86-92 is based on a 0.95-1.05x multiple of our projected 2010 book value. Risks to achieving our valuation range include large catastrophe losses, increased competition, a deterioration in loss costs, and a rise in D&O claims.

### Investment Thesis:

PartnerRe's strong competitive position within the reinsurance market will be further strengthened following the completion of the PARIS Re acquisition, in our opinion.

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**Please see page 3 for rating definitions, important disclosures and required analyst certifications**

## Company Description:

PartnerRe is a Bermuda-based, leading global reinsurer, providing coverage to more than 2,000 clients in more than 150 countries worldwide. It is currently the tenth-largest global reinsurance group. PRE offers all major property and casualty reinsurance products, but it is a leader in the specialty reinsurance lines of catastrophe, aviation, agriculture, credit and surety, marine, and global risks. PRE is rated 'A+' by A.M. Best and 'AA-' by S&P.

**Market Conditions**

- PRE described the current environment as “acceptable, although not great”. The company does not see anything in either the reinsurance or capital markets that could considerably alter conditions in the near-term.
- PRE expects the reinsurance industry’s profitability levels to remain in the high single digits and continued volatility with low-single digit returns in the capital markets.
- Management did point to some select pockets of opportunity for new business. In its non-life book, PRE could benefit from higher rates for both Latin American, mainly on facultative business, and in energy and marine lines, following the recent loss events.
- PRE expects its Life business to become a bigger contributor to premium over the next few years. The company is seeing more opportunity in longevity reinsurance deals, particularly in the UK. There is also increased demand for mortality reinsurance from European life insurers seeking capital relief prior to the implementation of Solvency II.

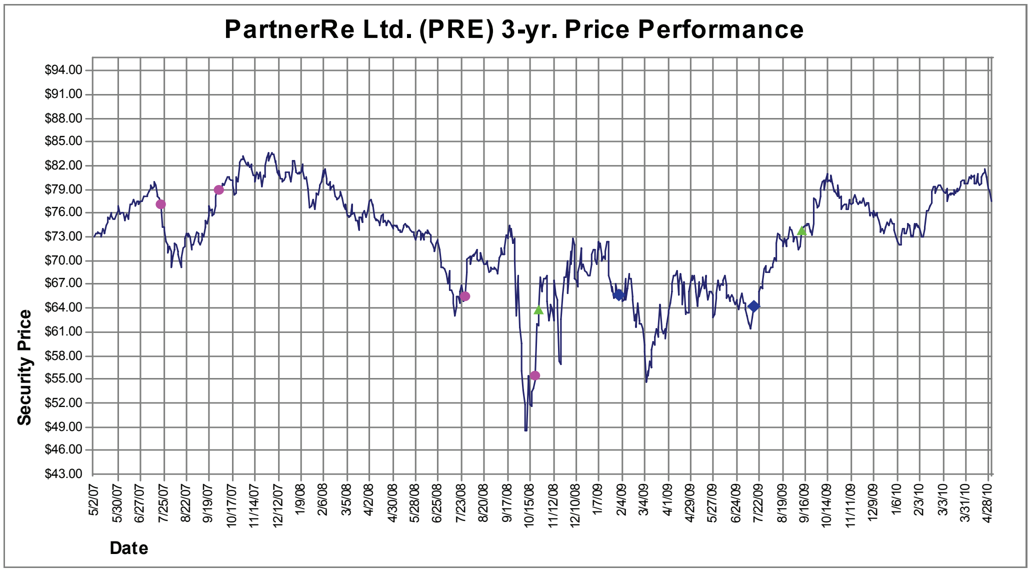
**PARIS RE Integration**

- Management stated that the PARIS integration is progressing as expected, with plans to operate as a single integrated entity as of July 1.
- Approximately 70% of the PARIS RE book has been renewed following both the January and April 1 renewals.
- As it had expected, PRE saw about a 20% reduction in PARIS RE premium during both the January and April 1 renewals (after adjusting for the business that moved over to PartnerRe paper). About half the decline was the at the client's option while the other was a function of a PRE decision to nonrenew.
-

**Deepwater Horizon Rig Loss**

- Last week, PRE provided an initial estimate regarding the sinking of the Deepwater Horizon rig loss in the range of $60-70 million pre-tax based on a $1 billion loss estimate. The loss will impact Q2 results, mainly in both the Global Specialty and PARIS RE subsegments.
- PRE’s has three exposures to the rig loss: (1) treaty exposure in old PRE book; (2) facultative exposure in PARIS RE; and (3) treaty exposure in PARIS RE book.
- Both the facultative and PRE exposure are capped by retrocession, so PRE is confident that 2/3 of the loss is capped.
- The PARIS RE treaty is not protected by retro, but PRE believes the any upward movement in loss estimate would not be that material – an additional $10-20MM in the worst case.
- PRE believes that the industry loss estimates of $3.5 billion are exaggerated and ‘impossible’ to hit given that it is simply the addition of all outstanding limits and that significant uncertainty exists because of the liability exposures. As a result, PRE sees no reason to change either its loss or industry estimates.

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 5/2/2007 | | Spivak | | | |
| | 5/2/2007 | NA | 2 | 72.00 | 74.00 | 73.02 |
| ● | 7/23/2007 | NA | 2 | 78.00 | 80.00 | 77.17 |
| ● | 10/1/2007 | 78.87 | 2 | 81.00 | 83.00 | 78.87 |
| ● | 7/28/2008 | 65.37 | 2 | 71.00 | 73.00 | 65.37 |
| ● | 10/22/2008 | 55.50 | 2 | 63.00 | 65.00 | 55.50 |
| ▲ ● | 10/27/2008 | 61.78 | 1 | 74.00 | 76.00 | 63.76 |
| | 2/2/2009 | | Hausner | | | |
| ◆ | 2/2/2009 | 65.74 | SR | NE | NE | 65.74 |
| | 7/15/2009 | | Hall | | | |
| ◆ | 7/15/2009 | 64.30 | 2 | 68.00 | 73.00 | 64.30 |
| ▲ ● | 9/11/2009 | 71.79 | 1 | 86.00 | 92.00 | 73.87 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- ❐ Split Adjustment

**Rating Code Key**
- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

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**2=Market Perform:** The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD
**3=Underperform:** The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

## SECTOR RATING

**O=Overweight:** Industry expected to outperform the relevant broad market benchmark over the next 12 months.
**M=Market Weight:** Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.
**U=Underweight:** Industry expected to underperform the relevant broad market benchmark over the next 12 months.

## VOLATILITY RATING

**V** = A stock is defined as volatile if the stock price has fluctuated by +/-20% or greater in at least 8 of the past 24 months or if the analyst expects significant volatility. All IPO stocks are automatically rated volatile within the first 24 months of trading.

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SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE

May 7, 2010

WELLS FARGO SECURITIES

# *Equity Research*

## Pebblebrook Hotel Trust

**PEB: Will Have $320MM Post Acquisition, Lowering Ests.**

**Outperform / V**

Sector: Lodging
Underweight

- SUMMARY. Pebblebrook management continues to see an increase in the volume of acquisition opportunities either through marketed or quiet/exclusive deals and remains confident in its ability to complete what it views as its fair share of acquisitions. PEB announced it signed a P&S for a $67MM hotel in the DC/Baltimore area, its first hotel, with closing expected within 45 days. With ~$320MM in cash post acquistiion, we believe the company is well positioned to acquire at a 30-50% discount to replacement. We estimate 2010-2012 FFO/sh will be $0.07, $1.41, & $1.73, down from $0.14, $1.95 & $2.32. VR is $20-23.
- Q1 ABOVE ESTS. The company reported FFO/sh of ($0.03), $0.02 above our estimate/consensus. G&A costs were inline while interest income accounted for the $0.02 differential. The company currently owns no assets.
- ANNOUNCES AGREEMENT FOR FIRST ACQUISITION. Pebblebrook announced the execution of a P&S for a $67MM hotel in the DC/Baltimore area. Typically a lodging REIT would not announced a P&S, however the SEC mandates disclosure of the agreement as the company is a blind pool REIT and as it would exceed 15% of its fixed assets. The company would have $320MM in cash post acquisition, or $15.75 per share.
- ADJUSTING ESTIMATES. We would expect estimates for the company to move around notably at least until it has fully utilized its initial offering proceeds, which we expect could be by 2012, due to differences in timing, pricing and terms of acquisitions, as well as initial yields, seasonality, and cap ex needs, among other variables. We estimate 2010-2012 FFO/sh will be $0.07, $1.41, and $1.73, down from $0.14, $1.95 and $2.32.
- RECOVERY FASTER THAN INITIALLY EXPECTED, U.S. OUTLOOK UP. Management now expects 2010 U.S. RevPAR to increase 1-3%, up from its prior expectation of flat to down slightly, as provided less than 45 days ago. Business and group demand has improved faster than initially expected, although both segments remain price sensitive. Management expects rate increases to occur before year end, aided by the improvement in higher rated transient demand.

### *Earnings Estimate Revised Down*

| | 2009A | 2010E | | 2011E | |
|---|---|---|---|---|---|
| **FFO** | | **Curr.** | **Prior** | **Curr.** | **Prior** |
| **Q1** (Mar.) | NA | ($0.03) A | NC | **$0.15** | **0.23** |
| **Q2** (June) | NA | (0.06) | NC | **0.36** | **0.50** |
| **Q3** (Sep.) | NA | **0.07** | **0.08** | **0.45** | **0.64** |
| **Q4** (Dec.) | (0.04) | **0.09** | **0.17** | **0.44** | **0.57** |
| **FY** | ($0.04) | **$0.07** | **0.14** | **$1.41** | **1.95** |
| **CY** | ($0.04) | $0.07 | | $1.41 | |
| **FY P/FFO** | NM | 266.7x | | 13.2x | |
| **Rev.(MM)** | NA | $26 | | $179 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

| | |
|---|---|
| Ticker | PEB |
| Price (05/07/2010) | $18.67 |
| 52-Week Range: | $18-23 |
| Shares Outstanding: (MM) | 20.3 |
| Market Cap.: (MM) | $378.3 |
| S&P 500: | 1,120.79 |
| Avg. Daily Vol.: | 143,627 |
| Dividend/Yield: | $0.00/0.0% |
| LT Debt: (MM) | $0.0 |
| LT Debt/Total Cap.: | 0.0% |
| ROE: | 12.0% |
| 3-5 Yr. Est. Growth Rate: | 10.0% |
| CY 2010 Est. P/FFO-to-Growth: | 26.7x |
| Last Reporting Date: | 05/06/2010 After Close |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

**Valuation Range: $20.00 to $23.00** **from $22.00 to $24.00**
Pebblebrook has no hotel investments at this time but cash on hand of ~$19/sh; we project full investment by 2012. Our 12-month valuation range is based on 13-14x 2013E EBITDA using 12% discount rates. Risks to achieving our valuation range include acts of/threats of terrorism, slower than anticipated acquisition pace, unfavorable acquisition pricing, inability to leverage acquisitions as expected, or a weak recovery in lodging profits or the broader U.S. economy.

**Investment Thesis:**
Hotels have experienced the greatest stress of all commercial real estate sectors, with industry EBITDA and asset prices down nearly 50%. We believe well-capitalized investors, particularly those unburdened by an existing balance sheet or portfolio constraints such as Pebblebrook, are best positioned to acquire high quality assets that can generate outsized returns. In the very near-term, we feel there is risk to hotel REIT valuations but believe Pebblebrook provides an attractive, defensive alternative as it is a cash alternative that retains its upside potential.

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**Please see page 4 for rating definitions, important disclosures and required analyst certifications**

## Company Description:

Pebblebrook Hotel Trust is an internally managed hotel investment company focused on investing in full-service hotel properties located primarily in major United States cities, with an emphasis on the major coastal markets. Traditionally these markets have a lack of cost-effectively developable land, which mitigates the risk of new room supply. Demand growth in these markets, however, tends to surpass national trends due to outsized economic activity and a disproportionate share of the U.S. population. Because of the favorable imbalance between supply and demand fundamentals, these markets historically experience the most robust recovery in net room demand growth as the U.S. economy improves.

Q1 2010 Operating Results
Pebblebrook Hotel Trust reported FFO per share of ($0.03), $0.02 above our estimate/consensus. G&A costs were inline with our estimate while interest income accounted for the $0.02 differential. The company currently owns no assets.

Pebblebrook announced the execution of a purchase and sale agreement (P&S) for a $67 million hotel in the Washington DC/Baltimore area. Typically a lodging REIT would not announced a P&S, however the SEC mandates disclosure of the agreement as the company is a blind pool REIT and as it would exceed 15% of its fixed assets. The transaction is expected to close within 45 days. At closing, management expects to provide significant detail, including financial history and projections, for the hotel. The company would have approximately $320 million in cash post acquisition, or $15.75 per share.

With every passing week, management is seeing an increase in the volume of acquisition opportunities either through marketed or quiet/exclusive deals and remains confident in its ability to complete what it views as its fair share of acquisitions. It continues to expect to be able to acquire assets at a 30-50% discount to replacement cost and are targeting initial yields of 6-7.5% and unlevered IRRs of 9.5-12%.

Adjusting Estimates
We would expect estimates for the company to move around notably at least until it has fully utilized its initial offering proceeds, which we expect could be by 2012, due to differences in timing, pricing and terms of acquisitions, as well as initial yields, seasonality, and cap ex needs, among other variables. Assuming the company acquires three hotels in 2010 and eleven in 2011 and by 2015 is yielding 12%, we estimate 2010-2012 FFO per share will be $0.07, $1.41, and $1.73, down from $0.14, $1.95 and $2.32.

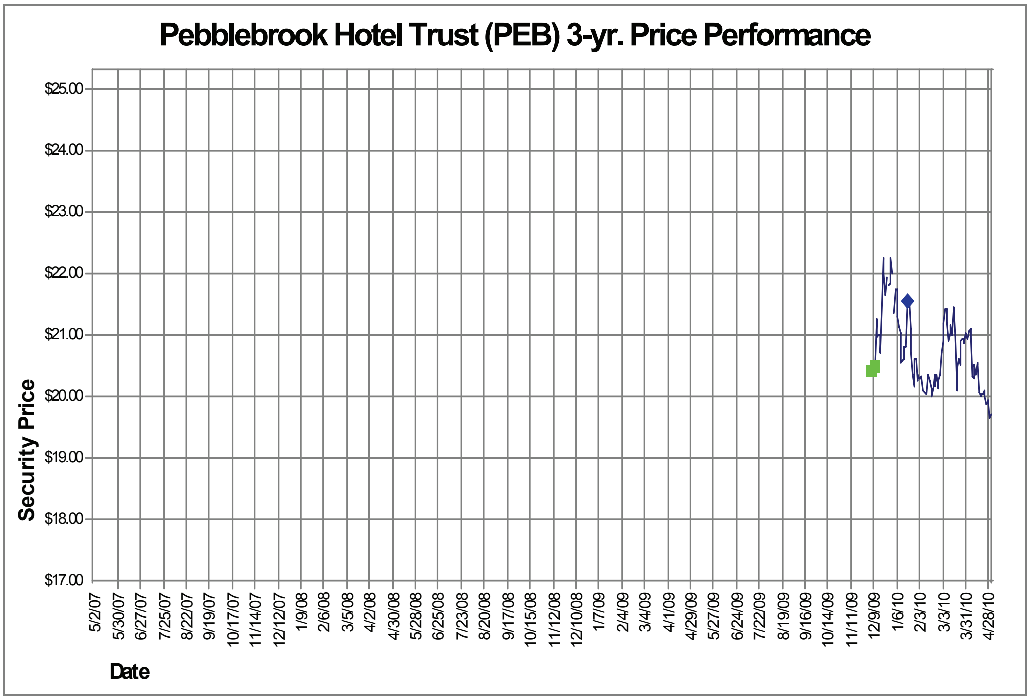
2010 Industry Outlook Raised
Management now expects 2010 U.S. RevPAR to increase 1-3%, up from its prior expectation of flat to down slightly, as provided less than 45 days ago, with rate down slightly. Both business and group demand has improved faster than initially expected, although both segments remain price sensitive. Management expects rate increases to occur before year end, aided by the improvement in higher rated transient demand. The company maintained its own expectation for corporate G&A.

**Pebblebrook Hotel Trust**
(Dollars values are in thousands, except per share results)
Summary Financial Model 2010E to 2012E

| Revenues | Q1 2010A | Q2 2010E | Q3 2010E | Q4 2010E | 2010E | Q1 2011E | Q2 2011E | Q3 2011E | Q4 2011E | 2011E | 2012E |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Rooms | - | 652 | 6,615 | 9,095 | **16,362** | 13,302 | 24,659 | 32,815 | 40,636 | **111,412** | **171,731** |
| Food And Beverage | - | 296 | 3,121 | 4,533 | **7,950** | 6,371 | 11,199 | 15,483 | 20,058 | **53,110** | **79,479** |
| Other | - | 88 | 941 | 1,090 | **2,119** | 1,729 | 3,329 | 4,666 | 4,824 | **14,549** | **22,057** |
| **Total Revenue** | **-** | **1,036** | **10,677** | **14,718** | **26,431** | **21,402** | **39,187** | **52,964** | **65,518** | **179,071** | **273,268** |
| **Expenses** | | | | | | | | | | | |
| Rooms | - | 189 | 1,885 | 2,728 | **4,803** | 4,123 | 7,151 | 9,352 | 12,191 | **32,818** | **49,066** |
| Food And Beverage | - | 206 | 2,138 | 3,287 | **5,630** | 4,683 | 7,783 | 10,606 | 14,542 | **37,613** | **55,589** |
| Other Direct | - | 43 | 456 | 534 | **1,034** | 865 | 1,631 | 2,263 | 2,364 | **7,123** | **10,606** |
| Indirect | - | 269 | 2,776 | 3,753 | **6,798** | 5,511 | 10,287 | 13,903 | 16,871 | **46,572** | **73,812** |
| Hotel Operating Expenses | - | 707 | 7,256 | 10,302 | **18,265** | 15,182 | 26,852 | 36,124 | 45,967 | **124,125** | **189,074** |
| Depreciation And Amortization | - | 402 | 1,093 | 1,670 | **3,165** | 2,551 | 4,072 | 5,981 | 7,989 | **20,593** | **36,262** |
| G&A | 1,576 | 1,751 | 1,926 | 2,197 | **7,450** | 2,076 | 2,176 | 2,276 | 2,426 | **8,954** | **9,904** |
| Interest Expense | - | - | - | - | **-** | 313 | 1,360 | 2,997 | 4,900 | **9,569** | **25,398** |
| Interest Income | (977) | (679) | (560) | (479) | **(2,695)** | (569) | (479) | (347) | (210) | **(1,605)** | **(350)** |
| Taxes & Insurance | - | 285 | 489 | 694 | **1,468** | 1,139 | 1,813 | 2,523 | 3,269 | **8,744** | **13,145** |
| Other Expense/Transaction Costs | - | 150 | 150 | 150 | **450** | 200 | 200 | 200 | 200 | **800** | **1,000** |
| **Total Expenses** | **599** | **2,616** | **10,353** | **14,534** | **28,103** | **20,891** | **35,994** | **49,754** | **64,541** | **171,180** | **274,433** |
| **Net Income (Loss) - Continuing** | **(599)** | **(1,580)** | **324** | **184** | **(1,672)** | **511** | **3,193** | **3,210** | **977** | **7,891** | **(1,166)** |
| **EBITDA** | **(599)** | **(1,178)** | **1,417** | **1,854** | **1,493** | **3,374** | **8,625** | **12,188** | **13,866** | **38,053** | **60,495** |
| **FFO Reconciliation** | | | | | | | | | | | |
| Net Income | (599) | (1,580) | 324 | 184 | **(1,672)** | 511 | 3,193 | 3,210 | 977 | **7,891** | **(1,166)** |
| Depreciation And Amortization | - | 402 | 1,093 | 1,670 | **3,165** | 2,551 | 4,072 | 5,981 | 7,989 | **20,593** | **36,262** |
| **Funds From Operations** | **(599)** | **(1,178)** | **1,417** | **1,854** | **1,493** | **3,061** | **7,265** | **9,191** | **8,966** | **28,483** | **35,096** |
| Weighted Average Shares | 20,260 | 20,260 | 20,260 | 20,260 | **20,260** | 20,260 | 20,260 | 20,260 | 20,260 | **20,260** | **20,260** |
| **FFO/Share** | **$ (0.03)** | **$ (0.06)** | **$ 0.07** | **$ 0.09** | **$ 0.07** | **$ 0.15** | **$ 0.36** | **$ 0.45** | **$ 0.44** | **$ 1.41** | **$ 1.73** |
| **FAD/Share** | **$ (0.03)** | **$ (0.06)** | **$ 0.06** | **$ 0.07** | **$ 0.04** | **$ 0.11** | **$ 0.29** | **$ 0.36** | **$ 0.33** | **$ 1.10** | **$ 1.13** |
| Dividends Per Share | $ - | $ - | $ - | $ 0.02 | **$ 0.02** | $ 0.05 | $ 0.09 | $ 0.13 | $ 0.17 | **$ 0.44** | **$ 0.68** |

Source: Wells Fargo Securities, LLC estimates and company documents

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| ❐ | 12/9/2009 | | IPO at $20.00 | | | |
| | 1/19/2010 | | Donnelly | | | |
| ◆ | 1/19/2010 | 20.82 | 1 | 22.00 | 24.00 | 21.54 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- ❐ Split Adjustment

**Rating Code Key**

| | | | |
|---|---|---|---|
| 1 | Outperform/Buy | SR | Suspended |
| 2 | Market Perform/Hold | NR | Not Rated |
| 3 | Underperform/Sell | NE | No Estimate |

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As of: May 7, 2010

| | |
|---|---|
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May 7, 2010

*Equity Research*

WELLS FARGO SECURITIES

## This Week In Wells Fargo Securities Pharma

Sector Rating: Generic Drugs, Overweight
Sector Rating: Specialty Drugs, Market Weight
Sector Rating: Large Cap Pharmaceuticals, Market Weight

| | | Price | FY EPS | | FY P/E | |
|---|---|---|---|---|---|---|
| **Company Name** | **Rati** | **05/07** | **2010E** | **2011E** | **2010** | **2011** |
| **Generic Drugs** | | | | | | |
| Impax Laboratories, Inc. | 1 V | $17.32 | $2.84 | $1.25 | 6.1x | 13.9x |
| Mylan Inc. (MYL) | 2 V | 21.50 | 1.61 | 1.89 | 13.4x | 11.4x |
| Teva Pharmaceutical | 1 | 57.53 | 4.56 | 5.39 | 12.6x | 10.7x |
| Watson Pharmaceuticals, | 1 | 42.31 | 3.36 | 3.80 | 12.6x | 11.1x |
| **Specialty Drugs** | | | | | | |
| Cumberland | 1 V | 10.05 | 0.44 | 1.64 | 22.8 | 6.1x |
| Endo Pharmaceuticals | 2 | 21.31 | 3.16 | 3.20 | 6.7x | 6.7x |
| King Pharmaceuticals, Inc. | 1 V | 9.82 | 0.82 | 0.86 | 12.0x | 11.4x |
| MannKind Corporation | 1 V | 6.25 | 0.00 | (1.01) | NM | NM |
| Medicis Pharmaceutical | 1 V | 23.50 | 2.05 | 2.33 | 11.5x | 10.1x |
| Pozen Inc. (POZN) | 2 V | 8.44 | 0.02 | 0.48 | 422. | 17.6x |
| Salix Pharmaceuticals, Ltd. | 2 V | 36.94 | (0.24) | 1.45 | NM | 25.5x |
| Valeant Pharmaceuticals | 3 V | 45.41 | 2.61 | 3.06 | 17.4x | 14.8x |
| VIVUS, Inc. (VVUS) | 2 V | 11.08 | (0.94) | (0.16) | NM | NM |
| Warner Chilcott Ltd. | 1 V | 24.51 | 3.34 | 3.70 | 7.3x | 6.6x |
| **Large Cap Pharmaceuticals** | | | | | | |
| Bristol-Myers Squibb Co. | 1 | 24.48 | 2.12 | 2.25 | 11.6x | 10.9x |
| Eli Lilly & Company (LLY) | 2 | 34.56 | 4.46 | 4.61 | 7.8x | 7.5x |

*Source: Company data and Wells Fargo Securities, LLC estimates 1= Outperform, 2 = Market Perform, 3 = Underperform, V = Volatile*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

- **For the week ending mid-day May 7, the Generic Drug group fell 2.4% while the Specialty group fell 6.0%.** These compare to a 6.9% fall in the NASDAQ Composite Index and a 5.5% decrease for the S&P 500 Index.
- **Earnings Recap:** IPXL: 1Q Beat Driven By Generic Flomax, Further Upside Likely; KG: 1Q Missed Expectations, Long-term Thesis Intact; MRX: Strong 1Q, Guidance and Estimates Raised; Well-Positioned for Growth; TEVA: Solid 1Q 2010; VRX: 1Q Beat On R&D; VVUS: 1Q In-line - Next Major Catalyst In 3Q; WCRX: 1Q Slight Beat, Rev Missed - Maintain Outperform--But Will Need Patience.
- **BMY: Belatacept Received CRL With Minor Issues -- Lowered Estimates** - We now expect mid-2011 approval.
- **LLY: Exenatide Once-Weekly (Bydureon) Receives New Timeline** - Class 2 resubmission; New PDUFA date is set for October 22, 2010.
- **POZN: Vimovo Approval Long-Term Positive -- Lowered Near-Term Estimates** - Believe NT share price movement may be restrained.
- **SLXP: Presented Additional Xifaxan Phase III Data** - SLXP expects to submit the NDA for Xifaxan 550mg in non-C IBS (or IBS-D) before the end of 2Q.
- **WPI: Confirmed Evista Patent Challenge** - Annual sales of Evista are ~$690MM.
- **Earnings Report Next Week: 5/10 - WPI, SLXP; 5/13 - CPIX**


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**Please see page 7 for rating definitions, important disclosures and required analyst certifications**

## Price Performance

- On average, the Generic Drug Group fell 2.4% for the week, compared to a 6.9% decrease for the NASDAQ Composite and 5.5% decrease for the S&P 500 Index.
- The Specialty Drug Group on average fell 6.0% for the week.

### Exhibit 1. Price Performance – Coverage Universe

| | | | Price Performance - % Change | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Company** | **Ticker** | **Price ($)*** | **Week** | **YTD** | **1-mth** | **3-mth** | **6-mth** | **52-wk** |
| **Large Cap Drug Group** | | | | | | | | |
| Bristol-Myers Squibb Co. | BMY | 24.53 | (3.1%) | (2.9%) | (7.6%) | 2.3% | 8.3% | 23.1% |
| Eli Lilly & Company | LLY | 34.81 | (0.5%) | (2.5%) | (4.7%) | 0.8% | 0.9% | (2.9%) |
| **Generic Drug Group** | | | | | | | | |
| Impax Laboratories | IPXL | 17.41 | (3.8%) | 27.9% | (3.5%) | 28.0% | 78.6% | 191.1% |
| Mylan Laboratories | MYL | 21.51 | (2.3%) | 16.7% | (5.3%) | 20.2% | 23.1% | 60.2% |
| Teva Pharmaceutical | TEVA | 57.63 | (1.9%) | 2.6% | (9.3%) | 1.5% | 10.8% | 29.7% |
| Watson Pharmaceutical | WPI | 42.04 | (1.8%) | 6.1% | 0.1% | 10.1% | 18.9% | 41.4% |
| **Specialty Drug Group** | | | | | | | | |
| Cumberland Pharmaceuticals | CPIX | 10.05 | (5.6%) | (26.0%) | (5.3%) | (15.6%) | (19.1%) | |
| Endo Pharmaceuticals | ENDP | 21.42 | (2.2%) | 4.4% | (8.7%) | 9.5% | (6.9%) | 31.5% |
| King Pharmaceuticals | KG | 9.77 | (0.3%) | (20.4%) | (19.3%) | (13.9%) | (12.8%) | 12.0% |
| MannKind Corporation | MNKD | 6.30 | (9.4%) | (28.1%) | (8.6%) | (28.0%) | 10.1% | 2.6% |
| Medicis Pharmaceuticals | MRX | 23.40 | (7.8%) | (13.5%) | (11.0%) | 5.1% | 3.1% | 50.0% |
| Pozen Inc. | POZN | 8.32 | (23.3%) | 39.1% | (20.7%) | 42.5% | 48.3% | 13.5% |
| Salix Pharmaceuticals | SLXP | 37.24 | (7.2%) | 46.7% | (3.2%) | 35.9% | 77.8% | 257.0% |
| Valeant Pharmaceuticals | VRX | 45.35 | 0.8% | 42.7% | 3.0% | 31.8% | 39.6% | 138.3% |
| Vivus Inc | VVUS | 11.02 | 8.1% | 19.7% | 24.6% | 32.4% | 49.1% | 150.3% |
| Warner Chilcott Ltd | WCRX | 24.61 | (13.2%) | (13.6%) | (4.5%) | (3.6%) | 7.2% | 119.9% |
| Generic Drug Group Average | | | (2.4%) | 13.3% | (4.5%) | 15.0% | 32.8% | 80.6% |
| Specialty Drug Group Average | | | (6.0%) | 5.1% | (5.4%) | 9.6% | 19.6% | 86.1% |
| NASDAQ | | 2,291.53 | (6.9%) | 1.0% | (5.7%) | 7.0% | 8.5% | 33.5% |
| S&P 500 | | 1,121.20 | (5.5%) | 0.5% | (5.2%) | 5.2% | 4.9% | 23.6% |

*Intra-day price as of May 7, 2010
Source: FactSet

## News Digest

### <u>Large Cap Pharmaceuticals</u>

**BMY: Belatacept Received CRL With Minor Issues--Lowered Estimates**

- BMY received a CRL for its solid organ transplant rejection product, belatacept. The complete response letter does not request additional new preclinical or clinical trials. However, the FDA requested the 36-month data from BMY's ongoing Phase III studies in order to evaluate the long-term effect of belatacept. Other issues raised in the letter relate primarily to the Risk Evaluation and Mitigation Strategy (REMS).
- BMY expects the 36-month data to be available this summer. Our new timeline for belatacept is: 36-month data available summer 2010; re-filing with FDA around year-end 2010; final approval mid-2011 (assuming a six-month turnaround). We believe this timeline is achievable and could prove conservative by several months.
- We believe the CRL is actually a modest positive for BMY as it presents a clear pathway to approval. As such, we raised our probability of approval from 66.7% to 80%. We previously assumed a mid-2010 approval, but pushed that out to mid-2011. Recall, an FDA panel voted 13-5 in favor of Belatacept at its March 1, 2010 committee meeting.
- Lowered 2010 EPS from $2.13 to $2.12 due to the delay and prior mid-2010 approval estimate. We also lowered our 2011 EPS from $2.26 to $2.25, due to the delay.
- Maintain Outperform rating. While the delay is certainly not as positive as an outright approval, we believe it provides BMY with a clear pathway to approval. We believe BMY is well positioned longer term with the potential to launch five new products (belatacept, apixaban, dapagliflozin, ipilimumab, brivanib) by the end of FY2012.
- Separately, BMY's board authorized a $3 billion share repurchase program.

**LLY: Exenatide Once-Weekly (Bydureon) Receives New Timeline**

- LLY announced that the FDA has classified the Exenatide once-weekly (Bydureon) CRL as a Class 2 resubmission (6-month review). The new PDUFA date is set for October 22, 2010.
- Recall, LLY received a complete response letter on March 15. The issues raised in the letter relate primarily to product labeling and a Risk Evaluation and Mitigation Strategy (REMS).
- Final approval is likely in 2H 2010, in our view. We believe this represents a modest positive for LLY, but does not substantially enhance LLY's growth prospects in the near to intermediate term.
- Bydureon is a once-weekly formulation of Byetta (GLP-1 receptor agonist). Byetta has been available in the US since June 2005.

### <u>Specialty Pharmaceuticals</u>

**IPXL: 1Q Beat Driven By Generic Flomax, Further Upside Likely – Raised Estimates**

- Higher confidence in generic Adderall XR duopoly drive increased optimism. Following the advisory panel meeting on bioequivalence, we are more confident of status quo for generic Adderall XR in 2010, and cautiously optimistic about extension into 2011.
- Raised 2010 and 2011 estimates. New 2010 EPS estimate of $2.84 (from $1.10) reflects primarily 1Q actual results and strong underlying business. New 2011 EPS estimate of $1.25 (from $0.81) reflects more optimistic outlook for generic Adderall XR. Our model could still be conservative, as it includes modest new product launches, no monetization of Para IV opportunities, and no marketed product acquisitions.
- Upside/downside scenario favorable. The earnings power of the underlying business provides downside protection, in our view. Our bear case analysis suggests a $15-$16 stock, while our bull case analysis suggests a $23-$24 stock. Our analysis excludes business development activities. A modest acquisition could nudge the bear case toward the current share price, providing further downside protection.

- 1Q 2010 far exceeded consensus, driven by generic Flomax. Adjusted EPS was $2.05, compared with $0.51 consensus and our $0.43 estimate. Generic Flomax contributed ~$1.64 in EPS. While the exclusivity period for generic Flomax has ended, we note that the rest of IPXL's business delivered ~$0.41 in EPS, suggesting an annualized run rate of ~$1.60.

**KG: 1Q Missed Expectations, Lowered Estimates, Long-term Thesis Intact**

- Lowered 2010 and 2011 cash EPS estimates. Our new estimates are $0.82 (vs. $1.02 prior) and $0.86 (vs. $1.09 prior). Our revisions primarily reflect the actual 1Q results and moderated near-term outlook for Embeda and Flector, partially offset by SG&A expense reduction.
- Long-term thesis intact. We continue to believe KG's abuse-deterrent opioid platform is the long-term value driver. On-time submission of Remoxy (4Q 2010E) and Acurox without niacin (1Q 2011E), and progress with oxycodone NT, Acuracet, and Vycavert could drive shares higher, in our view.
- Key 1Q takeaways: Remoxy and Acurox submissions on track, Animal Health segment retained, sales force resource to be reallocated to focus on more Embeda and Flector, management will restrain SG&A spend to offset near-term revenue headwind, management cool on the idea of share buyback/dividend payout.
- 1Q 2010 below expectations on weak top line and higher tax rate. KG reported adjusted EPS of $0.14 on $380.9MM in revenue. This compares to our estimates of $0.28 and $439.0MM and consensus of $0.24 and $427.7MM. We note, the higher than expected tax rate (46.7% A vs. 37.5% E) was a $0.03 drag on EPS. R&D expenses were $3.3MM above our estimate, but were offset by SG&A expenses that were $3.3MM below our target.

**MRX: Strong 1Q 2010, Guidance and Estimates Raised; Well-Positioned for Growth**

- Maintain Outperform: well-positioned for growth. Continued Rx strength in Solodyn and Ziana, Dysport gaining traction, and possible US approval of LipoSonix put MRX in a position for sustainable growth, in our view. At ~10.9x 2010E cash EPS we continue to believe MRX shares are undervalued.
- Raised 2010 and 2011 estimates. Our new estimates are $2.05 (vs. $1.91 prior) and $2.33 (vs. $2.18 prior) for 2010 and 2011, respectively. The corresponding cash EPS estimates (for valuation purposes) are $2.33 and $2.62. Our revision primarily reflects actual 1Q results and expectations that expenses will likely come in near the low end of mgmt's guidance range.
- Key takeaways from 1Q results: Solodyn remained strong, Ziana reinvigorated, Dysport gaining traction, LipoSonix filed.
- Key focus issues for mgmt: Dysport demand trend when (or if) the Dysport Challenge Program ceases, reduces dependence on Solodyn, mitigation of generic Solodyn risk, potential use of cash.
- 1Q 2010 significantly above consensus. EPS were $0.54 on revenue of $166.5 million. These compare favorably with consensus ($0.43 and $160MM) and our estimates ($0.42 and $161.1MM). Higher revenue contributed ~$0.05 to the EPS beat, while lower operating expenses contributed the rest of the upside.

**POZN: Vimovo Approval Long-Term Positive -- Lowered Near-Term Estimates**

- Near-term share price movement may be restrained--maintain Market Perform. The next leg up in share price will likely be driven by market uptake (Rx data), which should not be available until Q4 2010. Strong market uptake could prompt us to become more constructive on POZN shares. With recent new product launches in pharma ramping slower than before, investors will likely remain skeptical until Rx data prove otherwise.
- Vimovo approval bodes well for POZN long term. The resulting milestone payment and royalty revenue should provide POZN with the financial flexibility to pursue development and U.S. commercialization of PA32540 on its own. It also increases the likelihood of regulatory success for PA32540.

- Lowered near-term estimates. Lowered 2010 and 2011 EPS estimates to $0.02 and $0.48, down from $0.12 and $0.59, respectively. We slightly pushed out royalty recognition to Q4 2010 (from Q3), and are modeling a slower ramp to be consistent with our observations regarding recent new product launches in the pharmaceutical industry. Our model could be conservative, as market adoption of Vimovo could be more rapid than the recent trend in the industry.
- Financial impact: $20MM U.S. approval milestone, 10% royalty on U.S. sales. Pending approval in EU (MAA filed Oct 2009): $25MM EU approval milestone, tiered royalty (mid-single digits to mid/high teens) on international sales.

**SLXP: Presented Additional Xifaxan Phase III Data**

- SLXP presented data from its Phase 3 clinical trials (TARGET 1 and 2) evaluating the efficacy and tolerability of XIFAXAN 550 mg (rifaximin) in 1,260 patients with non-constipation IBS at the annual meeting of Digestive Disease Week (DDW).
- The data demonstrated that a 14-day course of XIFAXAN 550 mg (taken 3x daily) achieved adequate relief of IBS symptoms in a significantly greater proportion of patients during the first 4 weeks following 2 weeks of treatment, as well as over 3 months (2-week treatment plus 10-week follow-up), compared with placebo. The safety profiles were similar between XIFAXAN 550 mg and placebo.
- Recall, Xifaxan 550 was approved for overt HE at the end of March 2010, and is expected to launch the product this month.
- SLXP previously announced that it expects to submit the NDA for Xifaxan 550mg in non-C IBS (or IBS-D) before the end of 2Q 2010

**TEVA: Solid 1Q 2010, Raised Estimates**

- 2010 financial guidance should be readily achievable, in our view. TEVA reiterated its 2010 revenue and cash EPS guidance of $16B and $4.40-$4.60, respectively. The termination of payments to Sanofi (25% of US Copaxone sales) starting in 2Q, and generic launches of Cozaar/Hyzaar (4/2010) and Effexor XR (7/2010) should allow TEVA to comfortably hit its financial guidance for the year.
- Raised estimates slightly. Our new 2010 EPS estimate is $4.56 (vs. $4.54 prior), primarily reflecting the 1Q beat. We tweaked Europe sales lower, but offset it with stronger US generic sales. We also raised our 2011 EPS estimate to $5.39 from $5.23.
- Key takeaways from 1Q 2010 results: strong US business and global Copaxone sales; low-volume Copaxone sNDA accepted for filing; minimal financial impact from US healthcare reform; Ratiopharm transaction on track to close toward end of year; 39 possible launches (US) addressing $20B in brand sales for 2010; Women's Health weak but expect to rebound; cautious on near-term growth prospect in Europe, uncertainty in potential damages from at-risk generic Protonix launch remains a near-term overhang.
- 1Q 2010 adjusted EPS of $0.91 beat consensus ($0.89). Revenue was essentially in line with consensus ($3.66B vs. $3.69B E). Margins consistent with our model. R&D (5.7% of sales) below management target (6.0-6.5% of sales), but will ramp higher in 2Q-4Q. FX had minimal impact on bottom line.

**VRX: 1Q Beat On R&D; Raised Estimates**

- Maintained Underperform rating on rich valuation - execution is encouraging. At ~17.9x our 2010 cash EPS, VRX is trading at a 37%+ premium to its peers. Sustaining the current multiple requires flawless execution of VRX's growth through acquisition strategy via favorable borrowing rates, in our view. Current management has shown impressive execution over the last 5 qtrs and continued execution could get us more positive.
- Raised our 2010 cash EPS estimate to $2.61 from $2.37. The change was primarily driven by higher than expected revenue and lower R&D. Our new 2010 cash EPS estimate is slightly below the low end of management's new 2010 guidance of $2.65 - $2.90 (previously $2.45 - $2.70). Additionally, we introduced our 2011 cash EPS estimate of $3.06.

- Management raised 2010 financial guidance on the strength of the underlying business. VRX asserted that the increased guidance is the result of strength in its business. The acquisition of Aton Pharmaceuticals and the share repurchase merely offset the incremental interest expense from the $400 million notes offering.
- Additional 1Q takeaways: 1) Organic growth appears intact for now - 1Q results indicate that VRX's growth-through-acquisition story seems to be working, as the company delivered organic growth (ex-acquisitions and ex-FX) over the prior year period; 2) Management maintained margins despite weakness in EU and noted that EU is well on its way to recovery; 3) SG&A ticked up as a percentage of revenue - management attributed the increase to FX effects and expects it to reverse going forward.
- VRX reported 1Q 2010 cash EPS of $0.64 on revs of $232MM. Consensus estimates were $0.60 and $225MM. Our estimates were $0.63 and $231MM. Cash EPS excludes $19.3MM of amortization expenses, boosting the bottom line by about $0.14.

**VVUS: 1Q In-line; Next Major Catalyst In 3Q; Adjusted Estimates**

- Maintained Market Perform rating. Our Market Perform rating is based on some lingering uncertainties regarding chronic use of topiramate, uncertainties REMS requirement, as well as potential reimbursement challenges. We believe the next major catalyst for VVUS shares is the Qnexa FDA Advisory Panel meeting which is tentatively scheduled for July 15, 2010. We could get more positive on the stock if VVUS is able to secure a Qnexa marketing partner under terms better than we currently anticipate.
- Partnership potentially on the horizon. Management previously suggested that a Qnexa partnership agreement is unlikely to be completed until an FDA Advisory Panel recommends approval of the product. With the Advisory Panel tentatively scheduled for July 15, we believe a partnership announcement could come in the next several months. As we stated above, we could get more positive on VVUS shares if the company is able to secure a better than expected deal. Qnexa's PDUFA date is set for October 28, 2010.
- Raised our 2010 EPS estimate to ($0.94) from ($0.99). The change primarily reflects lower R&D expenses, as well as the 1Q beat. On the call, VVUS reaffirmed that it expects to burn ~$95 million in cash in 2010. We lowered our 2011 EPS estimate to ($0.16) from ($0.14). The change is driven by higher than expected OpEx.
- VVUS reported a 1Q 2010 per share loss of $0.23 on $1.7MM revenue. This compares to our EPS and revenue estimates of ($0.26) and $1.1MM, respectively. The beat was driven by better than expected revenue and lower R&D ($10.2MM A vs. $14.1MM E), partially offset by higher COGS ($2.4MM A vs. $1.6MM E). As an emerging biopharma company, we believe near-term financial results are less important than Qnexa news flow and pipeline progress.

**WPI: Confirmed Evista Patent Challenge**

- Annual sales of Evista are ~$690 million.

**WCRX: 1Q Slight Beat, Rev Missed; Raised Ests: Maintain Outperform--But Will Need Patience**

- Maintain Outperform. While we believe the near-term could be choppy, we continue to maintain our Outperform rating on WCRX. Our rating is based on our belief that a re-configured sales force could curb the slide in Actonel prescriptions, the Asacol franchise will continue to successfully transition to the HD formulation, and attractive valuation (7.3x our 2010 cash EPS estimate of $3.34, vs. peer group of 12-13x).
- We raised our 2010 cash EPS estimate to $3.34 from $3.32. The change primarily reflects a higher gross margin (lower COGS), partially offset by higher SG&A expenses. We also introduced our 2011 cash EPS estimate of $3.70. Management reiterated 2010 EPS guidance of $3.30 - $3.40, while changing several other metrics.
- Key takeaways: 1) Actonel TRx in the US declined 21.6% yoy. However, the decline appears to be decelerating (-24.2% in 2009). The PDUFA date for next-generation Actonel is July 2010; 2) Asacol transition to the HD formulation (800mg) remains a work-in-progress with encouraging recent TRx trends; and 3) Doryx the 150mg strength represented over 90% of franchise prescriptions. Reported revenue was below Rx demand trend due to contraction of trade inventory level.

- WCRX reported adjusted 1Q EPS of $0.88 on revenue of $688.6MM. This compares to our estimates of $0.96 and $739.9MM. Consensus estimates were $0.86 and $764.8MM. The revenue miss was driven by lower than expected results for Actonel (the international segment; $108.5MM A vs. our $132.2MM E), Doryx ($50.9MM A vs. our $64.2MM E), and other revenues ($43.8MM A vs. our $55.8MM E). SG&A came in ~$43MM above our $277.3MM estimate, while R&D was ~$6.8MM below our estimate.

## Earnings Preview

| | | | EPS | | | Revenue ($MM) | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Ticker | Earnings Release | Time | Consensus Estimate | Our Estimate | Last Year Actual | Consensus Estimate | Our Estimate | Last Year Actual | Call In # | Access Code |
| WPI | 5/10 | 8:30AM | $0.74 | $0.76 | $0.58 | $829.5 | $828.9 | $667.4 | (877) 251-7980 | |
| SLXP | 5/10 | 5:00PM | ($0.50) | ($0.51) | ($0.29) | $42.5 | $41.3 | $44.8 | (800) 441-0022 | |
| CPIX | 5/13 | 5:00PM | $0.02 | ($0.02) | - | $11.8 | $11.1 | $9.4 | 877-303-1298 | |

Source: FactSet and Wells Fargo Securities, LLC estimates

**WPI: Product flow and Sustainability of Current Product Momentum**

- Focus will be on expectations for new generic product flow, as well as expectations for additional competition in generic Toprol XL and Micro-K.
- We will also be looking for commentary regarding WPI's Branded Product segment.

**SLXP: Xifaxan 550mg Pre-Launch Activities**

- SLXP had already indicated a relatively weak 1Q, investor attention will be on the anticipated launch of Xifaxan 550mg in hepatic encephalopathy. Specifically, we believe investors will be looking for details regarding pre-launch activities, inventory stocking, and anticipated market adoption.

**CPIX: All Eyes on Caldalor Formulary Acceptance**

- We believe investors will primarily focus on management's comments regarding the formulary acceptance of Caldalor.
- We also look for updates on the sNDA filing for Acedtadote for acute liver failure, as well as potential pipline acquisitions.

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**BMY:** Risks to the stock trading to our valuation range include continued sluggish Onglyza prescription growth, development delay for dapagliflozin or ipilimumab, and continued regulatory setback for belatacept.
**CPIX:** Risks to the stock trading to our valuation range include slow market uptake of Caldolor and competitive pricing in the injectable non-opioid analgesic market.
**ENDP:** Risks to the stock trading to our valuation range include substantial deceleration in Opana ER and Voltaren Gel trajectories, earlier than expected generic entrants, and inability to bring pipeline products to the market.
**IPXL:** Risks to the stock trading to our valuation range include earlier than expected competition in generic Adderall XR, delays in obtaining FDA approvals due to adverse litigation outcomes and regulatory uncertainties, and a dilutive acquisition.
**KG:** Risks to the stock trading in our valuation range include persistent slow market uptake of Embeda, sluggish Flector growth, and significant delays in development of abuse-deterrent opioids.
**LLY:** Risks to the stock trading to our valuation range include disappointing market uptake of Effient, further regulatory setbacks to exenatide QW, and additional pipeline failures.
**MNKD:** Risks to the stock trading to our valuation range include significant delays to Afrezza approval, and failure to secure a partnership agreement for Afrezza on favorable terms.
**MRX:** Risks to our valuation range include substantial deceleration in Restylane and Solodyn, launch of an additional generic Solodyn, slow market adoption of Dysport, and significant regulatory delay of LipoSonix.
**MYL:** Risks to the stock trading at our valuation range include inability to properly integrate the Matrix and Merck Generics acquisitions, subpar performance at Dey, and inability to replace revenue from generic Depakote ER/Keppra.
**POZN:** Risks to the stock trading to our valuation range include a disappointing Vimovo launch, weakness in Treximet prescription numbers, and earlier-than-expected generic Treximet entry.
**SLXP:** Risks to the stock trading in our valuation range include regulatory delays for rifaximin in IBS-D, and significant deceleration in MoviPrep.
**TEVA:** Risks to the stock trading to our valuation range include significant deceleration in growth of Copaxone and Azilect, unexpected unfavorable currency movements, and pricing pressure on generic products.
**VRX:** Risks to the stock trading above our valuation range include positive developments for retigabine MR and continued flawless execution of marginal acquisitions.
**VVUS:** Risks to the stock trading in our valuation range include the inability to secure a marketing partner on favorable terms and FDA review delays.
**WCRX:** Risks to the stock trading to our valuation range include the inability to integrate PGP effectively and deceleration in core product growth.
**WPI:** Risks to the stock trading to our valuation range include deceleration in Rapaflo and Gelnique, delay in generic Ferrlecit approval, and earlier than expected Micro-K competition.

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| | |
|---|---|
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May 7, 2010

# *Equity Research*

WELLS FARGO SECURITIES

## Enterprise Software Weekly

### Cloud Computing And Storage Software

Sector Rating: Application Software, Overweight
Sector Rating: Infrastructure Software, Overweight

| | | Price | FY EPS | | FY P/E | |
|---|---|---|---|---|---|---|
| **Company Name** | **Rati** | **05/06** | **2010E** | **2011E** | **2010** | **2011** |
| **Application Software** | | | | | | |
| Adobe Systems Inc. (ADBE) | 2 V | $32.49 | $1.94 | $2.16 | 16.8x | 15.0x |
| Aspen Technology, Inc. | 1 V | 10.75 | (0.69) | (0.42) | NM | NM |
| Blackbaud, Inc. (BLKB) | 2 V | 22.01 | 0.96 | 1.09 | 22.9 | 20.2x |
| Deltek, Inc. (PROJ) | 2 V | 7.60 | 0.47 | 0.54 | 16.2x | 14.1x |
| Intuit Inc. (INTU) | 2 | 35.21 | 2.02 | 2.20 | 17.4x | 16.0x |
| Oracle Corporation (ORCL) | 1 | 23.91 | 1.62 | 1.89 | 14.8x | 12.7x |
| Salesforce.com, inc. (CRM) | 1 V | 80.90 | 1.10 A | 1.21 | 73.6 | 66.9x |
| SuccessFactors, Inc. (SFSF) | 1 V | 19.84 | 0.01 | 0.12 | 1984 | 165.3 |
| Unica Corp. (UNCA) | 2 V | 9.52 | 0.37 | 0.60 | 25.7x | 15.9x |
| Vocus Inc. (VOCS) | 1 V | 15.82 | 0.61 | 0.68 | 25.9 | 23.3x |
| **Infrastructure Software** | | | | | | |
| ArcSight, Inc. (ARST) | 1 V | 21.79 | 0.55 | 0.71 | 39.6 | 30.7x |
| McAfee, Inc. (MFE) | 2 V | 33.01 | 2.65 | 2.95 | 12.5x | 11.2x |
| Symantec Corp. (SYMC) | 1 V | 16.53 | 1.56 A | 1.57 | 10.6x | 10.5x |
| VMware, Inc. (VMW) | 2 V | 58.65 | 1.31 | 1.53 | 44.8 | 38.3x |
| Websense, Inc. (WBSN) | 1 V | 21.89 | 1.20 | 1.40 | 18.2x | 15.6x |

*Source: Company data and Wells Fargo Securities, LLC estimates 1= Outperform, 2 = Market Perform, 3 = Underperform, V = Volatile*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*


- Summary: This week we provide an overview of the relationship between the next-generation data center/cloud computing and storage technology, with a particular focus on the software elements involved. Just as the increasing volume and complexity in enterprise applications is driving new dynamics in compute technology, the increasing volume and complexity in enterprise data is driving new dynamics in storage technology – with the cloud computing model again providing the solution. We conclude that although the storage software market is relatively mature and is expected to generate modest growth overall, pockets of high above-category growth will likely emerge in those areas which support and enable the transition to next-generation cloud-based storage architectures.

- Public Company Spotlight: EMC Cloud Storage Initiatives.
- Private Company Spotlight: Acronis, Zetta, Virsto.
- Enterprise Software News.
- Upcoming Events.


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# Discussion

### Cloud Computing And Storage Software

This week we provide an overview of the relationship between the next-generation data center/cloud computing and storage technology, with a particular focus on the software elements involved. Just as the increasing volume and complexity in enterprise applications is driving new dynamics in compute technology, the increasing volume and complexity in enterprise data is driving new dynamics in storage technology – with the cloud computing model again providing the solution. *We conclude that although the storage software market is relatively mature and is expected to generate modest growth overall, pockets of high above-category growth will likely emerge in those areas which support and enable the transition to next-generation cloud-based storage architectures.*

The scope of our analysis spans both private enterprise data centers and emerging public storage clouds. Just as in the compute scenario, advances in providing scalable, reliable, cost-efficient, and high-performance storage for the enterprise can also be leveraged by large-scale public cloud service providers. Some storage use cases today, such as back-up and archiving (which don't necessarily require frequent access), are ready-made for the public cloud context today. And, over time, in addition to advances in storage architectures we see an increasing convergence between those architectures and high-performance networking – ultimately enabling enterprise-class on-demand public cloud storage for a growing number of core application contexts. In addition, the storage software we refer to abstractly can manifest itself concretely as either a part of a systems (hardware + software) vendor's solutions (e.g. EMC, NetApp) or as a software-only (management/tools) vendor's solutions (e.g. CA, BMC, Double-Take).

### Data Growth: An Exponential Reality, Unfazed By Economic Ups And Downs

Data growth appears to be wholly unaffected by economic volatility and during recessionary periods a gap emerges between storage capacity and tools and data volumes/complexity, in our view. We believe this implies that the next several years could be a time period of rich activity and turnover in storage architectures (these storage architecture cycles have historically lasted 15-20 years), ultimately driving a fresh wave of investment in next-generation private and public cloud storage technology.

We believe a number of trends are driving exponential **data growth** in the enterprise and include:

- The first trend is simply the **general data output of everyday business** – it is important to note that exponential data growth is not a new phenomenon, although the current level of data volume is at a sweet spot in the curve with respect to capacity (IDC's initial forecast on this topic suggested that 2007 would be the first time when the amount of digital information exceeded storage capacity), which in our view ensures that legacy storage systems and approaches will not get the job done over the next several years.

- The second, highly related trend is the **data output of broad categories of applications which are increasing their enterprise footprint** – these applications which include ERP, CRM, and analytics/BI, generate a significant amount of data through everyday use. Survey work from NetApp and marketing research firm AC Nielsen suggests that IT applications such as ERP, CRM, and corporate email are the leading drivers for data growth, contributing about 62% of total enterprise data.

- A third trend is the **increasing adoption of consumer technology in the enterprise** – consumer communication tools such as instant messaging, rich consumer data objects such as pictures, videos and other multimedia, and the vast array of social media, such as wikis, blogs, status updates, and more. In addition to the raw amount of data, some consumer technology further drives data growth through inherent qualities of the social network. The data generated by social networking for example grows much more rapidly due to the network effect (for each new node in the network, the number of connections across the social networking graph grows at least on the order of n^2).

- A fourth trend driving data growth is the **increasingly digital world, and the conversion of analog media and documents to digital versions**. We expect classes of increasingly resource-intensive digital media applications to exhibit significant growth in the enterprise, further straining the storage infrastructure.

- Lastly, the **proliferation of duplicate/redundant copies of enterprise data** is also contributing significantly to data growth – estimates from CMP Media Research suggest that enterprise data is duplicated as much as 50 to 500 times. We believe the often detached consumers and producers of data view storage as a seemingly endless resource in the ether, and therefore usage patterns around duplication of data are rarely efficient – creating an opportunity for technology to clean up the mess.

A recent May 2010 study from analyst firm IDC (sponsored by EMC) entitled “The Digital Universe Decade – Are You Ready?” contains several remarkable statistics around data growth:

- Last year, despite the global recession, the Digital Universe grew by 62% to nearly 800,000 petabytes (a petabyte is a million gigabytes), with projected growth this year at about 50% to nearly 1.2MM petabytes.

- Between 2009 and 2020, the information in the Digital Universe will grow by a factor of 44.

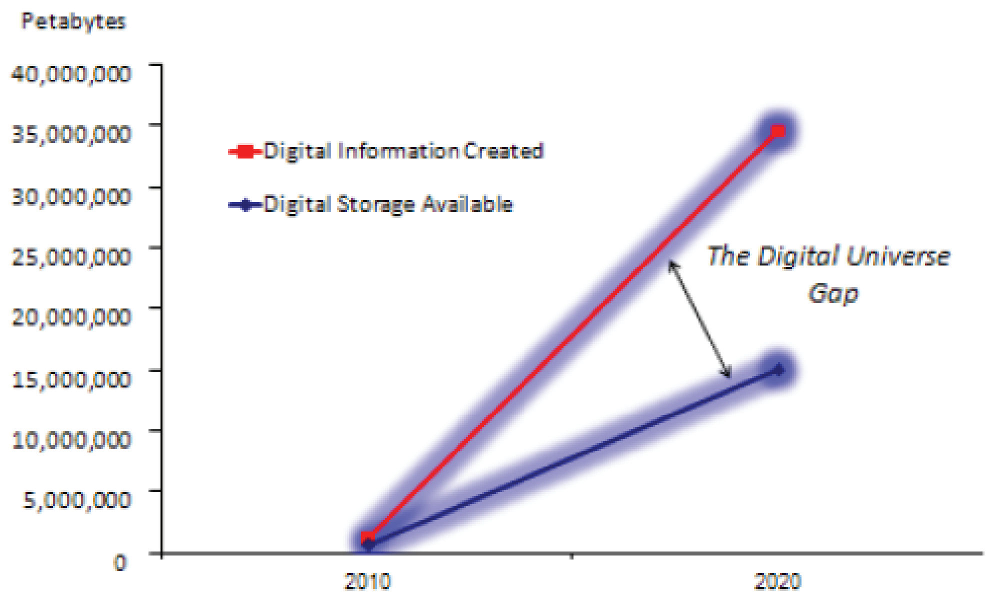
- Between 2009 and 2020, the number of data containers/files will grow by a factor of 67 to 25 quintillion (important because this is the level of granularity at which management of data operates).

- Between 2009 and 2020, storage capacity will grow by a factor of 30.

- In stark contrast, the staffing and investment to manage the Digital Universe will only grow by a factor of 1.4 – this data point in particular reflects our view that storage is an area in which cloud computing and next generation technologies will play a drastic role, as IT is forced to manage more with less by leveraging technology as opposed to operational costs or hardware capital costs.

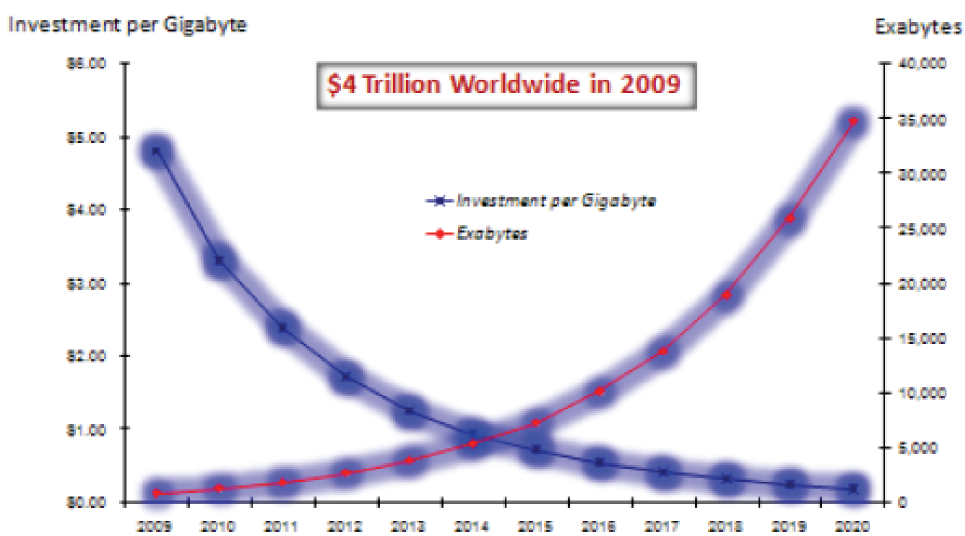
Source: IDC, Digital Universe Study, Sponsored By EMC, May 2010

**The Emerging Gap Between Information Creation And Storage Capacity**




Source: IDC, Digital Universe Study, Sponsored By EMC, May 2010

**The Decreasing Cost Of Managing Information**




Source: IDC, Digital Universe Study, Sponsored By EMC, May 2010

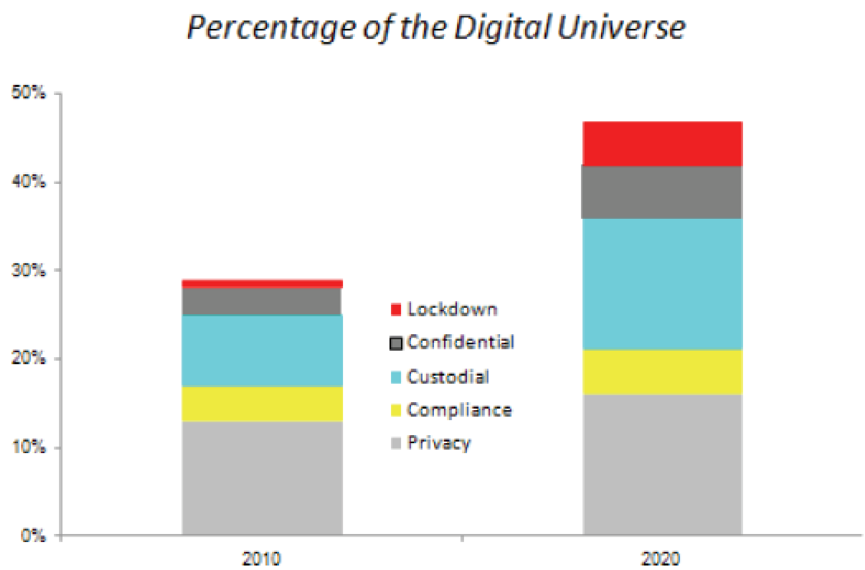
As outlined above, based on IDC projections, the pace of data and file/container growth is likely to meaningfully outpace storage capacity growth (44x, 67x versus 30x, respectively) and dramatically outpace IT spend (44x, 67x versus 1.4x, respectively). This creates two diverging gaps – one between storage capacity and storage requirements and another between storage requirements and available spend – placing an emphasis on better performance, greater utilization, and economic efficiencies from the intermediate storage technology.

**Complexity Further Exacerbates The Issue**

Not only is data growth a powerful force, but data complexity is placing an additional burden on CIOs responsible for storage strategies. In addition to data growth, a number of trends are driving increased **data complexity** and include:

- The first driver of greater complexity is **greater security requirements**. This further breaks down into two sub-drivers: the increasing threat landscape and mobility of data, which adds complexity to securing that data – storage systems must support increasingly data-centric security provisions. In addition, according to the Digital Universe Study by IDC, a greater proportion of data is moving to higher security zones. The study provides five broad security classifications from lowest requirement to highest – privacy only, compliance-driven, custodial data (such as account information), confidential data, and lockdown data. By 2020, the study estimates that almost 50% of information will require some form of security beyond a baseline level of virus protection and physical protection, up from about 30% this year. And, the portion of data requiring the highest level of security is projected to grow by a factor of 100. The total amount of unprotected data is expected to grow by a factor of 90 between 2009 and 2020.

**The Need For Information Security**




Source: IDC, Digital Universe Study, Sponsored By EMC, May 2010

- **Increasing compliance mandates** further build on data isolation/protection security requirements to ensure documents and enterprise data are retained for varying periods of time based on a plethora of changing and updated requirements. Compliance requirements around data are often driven by complex policies and place a burden on those responsible for archiving and enabling on-demand access to the relevant data. Regulatory compliance last year was a $46B industry, affecting nearly every organization in some way.

- In contrast to the early days of enterprise IT, when a large percentage of data was organized in databases, today we are witnessing an **explosion in unstructured data**, further driving complexity. Unstructured data (scattered text, digital media objects, social media interactions and updates, and any other type of new data that isn't organized in a database or annotated in documents) needs to be managed and prepared for analysis or manipulation. The ability to do this is important and drives tangible business results – for example, analyzing social media and networks in order to generate actionable marketing analytics or reading product log file information to aid and refine product development. However, by definition, unstructured data is in a form not easily digestible by applications – the burden to navigate the complexity of searching and organizing unstructured data is likely to fall to the storage layer, in our view.

- Today's fast-paced, increasingly real-time business environment imposes **high SLA requirements around performance and availability.** Implicit customer expectations or explicit service level agreements, storage must be fast and highly available, irrespective of the challenges posed by data growth. New classes of applications and application architectures are increasingly capable of quickly responding to changing business strategy, and therefore the underlying storage layer must adapt just as quickly.

- Lastly, and perhaps most importantly over the long-term, storage must adapt to **new and emerging compute models.** The enterprise compute infrastructure – as highlighted in our previous cloud computing reports – is composed of increasingly agile and virtualized servers and applications. The sprawl, mobility, and storage-sharing nature of these modern servers and applications drive greater complexity for storage. In addition, other than the typical, highly-penetrated enterprise apps outlined above (ERP, CRM, email, etc.), we have also increasingly observed the quest for enterprise-ready "high performance computing." Once reserved for large compute clusters in science/engineering contexts, a number of private companies and the cloud computing model are making HPC an emerging reality in the enterprise, in our view. The back-end to highly intensive computational clusters, however, is storage – and these new classes of applications add to complexity for the storage layer.

**The Cloud Model Is The Answer**

To summarize the implications of the above issues: the storage strategies for today's CIOs need to 1) do more with less investment, 2) increase storage utilization, 3) create a more agile and powerful storage environment, 4) enable elastic scalability and rapid provisioning, 5) enable more powerful management methodologies, 6) support multi-tenancy and data protection/isolation, and 7) be more self-service in nature in order to drive down IT support costs.

These requirements should sound familiar to readers of our Cloud Computing series – they are essentially the key definitional attributes of the cloud computing model outlined in our first weekly report on this theme. Indeed, analogous to trends in computing/server workloads, the storage industry is evolving to a cloud model as well in our view – intelligent and efficient storage architectures in the private cloud which will in time be seamlessly federated to emerging public cloud solutions. We discuss trends in the public storage cloud as an independent category in greater detail later in this report.

**Scale-Out Storage Architectures**

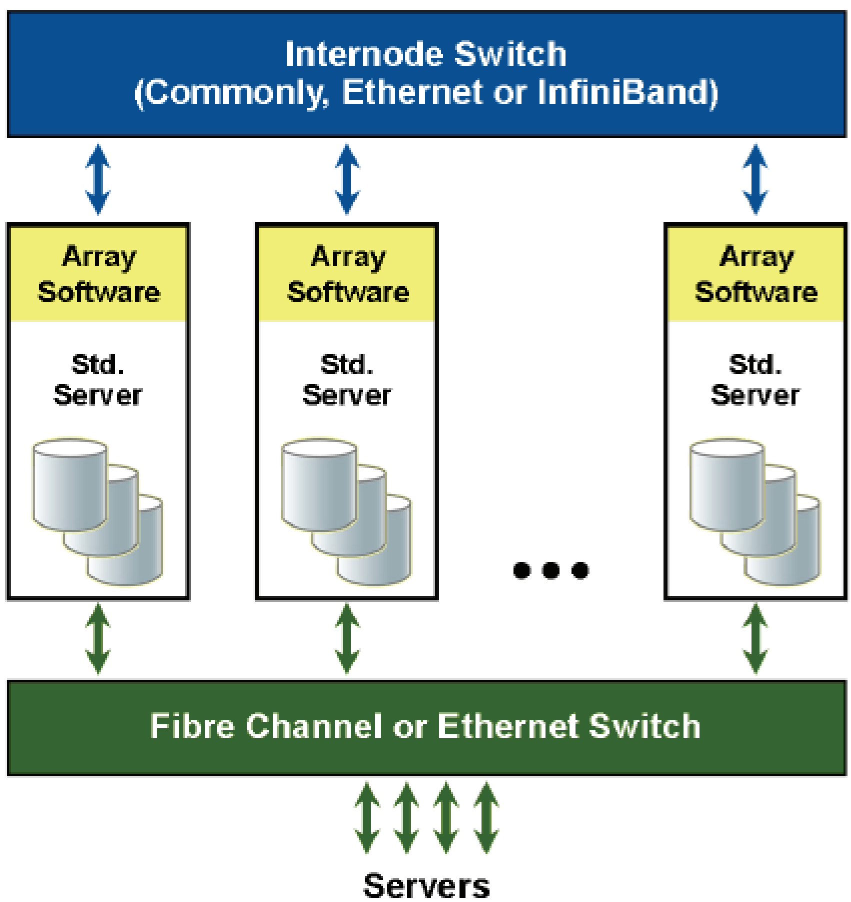
According to Surjit Sen, a NetApp executive, storage architectures have historically evolved in cycles of 15-20 years. Direct Attached Storage (DAS) was the primary model used in the 1990s and is currently on its last legs – DAS systems are composed of a data storage device directly connected to a server with no intermediate network. Utilization rates for DAS are relatively low – 30-40% -- and scaling typically requires investing in more hardware to solve the problem. In the late 1990s, Network Attached Storage (NAS) systems emerged to help organizations scale systems quickly by handling key challenges such as transactional I/O, rapid provisioning, and ease of deployment. Networked storage is still in the middle of its cycle and continues to grow in market share at the expense of DAS. However, we believe we are nearing another transitional stage in storage architectures – scale-out storage is the emerging model likely to take over.

NAS environments as single disk systems can only scale to a certain point even if they contain thousands of drives – an obvious limitation in an era of exponential data growth and the desire for large scale resource cloud models. As opposed to scale-up storage models, which scale vertically, scale-out storage scales horizontally – disks are added in *new* systems rather than in the same system. Multiple storage systems are pooled into a single logical storage resource. A key distinction of scale-out storage, in our view, is the increasing role software must play – both in providing the storage virtualization layer to enable the pooling of disparate systems as well as in managing the network/grid of commodity hardware components.

Sometimes termed "the serverization of storage," scale-out storage architectures fulfill the attributes of the cloud model by using standard commodity building blocks and intelligently linking them together using an overarching software layer to optimize cost/capability and overall resource utilization. Physical resources are also mapped to logical ones, reducing complexity from the user and administrator perspective.

Scale-out storage platforms are already the choice for tech vendors at the leading edge – Google's AppEngine uses Datastore and Amazon Web Services uses SimpleDB and S3, for example. Over time, the scale-out architecture and associated software will gain an increasing share of storage system spend, in our view.

**High-Level Schematic Of Scale-Out Storage Systems**




Source: Gartner (March 2010)

The benefits of scale-out storage architectures include: rapid deployment, easy to use, similar availability profile to more expensive high-end storage systems given enough storage nodes in the system, high levels of compute power per disk, leverage Moore's Law trends in processors and disks. Features provided in typical scale-out storage systems include: thin provisioning, space-efficient snapshots, remote replication, automatic load balancing, robust management tools, intelligent power management, and more. (Source: Gartner)

**Cloud Storage Models: Select Enabling Technologies To Watch**

1) **Storage Virtualization:** Storage virtualization software is one of the primary substrates required to create cloud-like scale-out storage architectures. Storage virtualization conceptually works similarly to server virtualization – the storage virtualization software layer allows physical storage resources to be treated as virtual/logical storage resources, driving superior utilization and agility. The specific implementation details vary greatly, however: while server virtualization uses a hypervisor in the specific/standardized x86 server context, storage virtualization software must be able to virtualize a vast array of types of storage systems and storage hardware components. NetApp's recent announcement (April 2010) to acquire Bycast, a storage virtualization provider for large-scale digital archiving and storage clouds is the latest investment by a systems provider in storage virtualization software for scale-out storage systems.

2) **Thin Provisioning:** Thin provisioning is a storage technique, perhaps best exemplified by 3PAR, in which virtual storage arrays allocate storage to a given application but release storage on the fly only when the capacity is actually required. As the initial capacity is used and a pre-determined threshold is reached, incremental storage capacity is allocated on the fly. Benefits include right-sizing storage (avoiding wasteful over-provisioning) and increasing utilization, as well as a reduction in administration overhead for provisioning storage.

3) **iSCSI:** Under a cloud/scale-out storage model, federation across multiple storage silos and "location-independence" are key. Users accessing or managing data should be able to consider storage as a logical entity without regard to specific storage system deployments. In order for this federation and abstraction to fully work, we believe storage and networking technologies will have to increasingly converge. iSCSI is an example of a storage/networking standard which we feel deserves special attention – iSCSI is an Internet Protocol based storage networking standard for connecting disparate storage environments. iSCSI enables the transfer of data over intranets and the Internet in order to seamlessly manage storage in a location-independent fashion. Organizations can use iSCSI to create central storage repositories, but storage will appear to be local from the perspective of the user. Indeed, in IDC's Worldwide Enterprise Storage Systems report from May 2009, iSCSI was the fastest growing storage installation environment with a 2008-2013 CAGR of 24.6%, versus DAS (-7.2%) and NAS (4.8%).

4) **Storage Management For Virtualized Server Environments:** Server virtualization continues to sit atop the strategic priority list for CIOs worldwide. The market remains significantly underpenetrated (we estimate 15%) and we believe that as virtualization management and automation solutions continually evolve, more and more compelling use cases are being discovered for the server virtualization model (beyond pure server consolidation). The cost, performance, and agility benefits of server virtualization cannot be ignored, yet the rapid growth in server virtualization creates a host of issues for the storage layer – this fact is not lost on leading virtualization vendors such as VMware, who have invested heavily in developing storage management solutions and APIs for storage vendors to develop solutions designed for the virtual world. Some issues created by rapid growth in server virtualization include:

   - Backup/recovery and other data protection models must change in order to adapt to server virtualization.

   - Virtual server sprawl and virtual machine mobility together imply both greater copies and more difficult to track copies of server images and workloads in the data center and require storage management attention. Due to virtual machine sprawl, virtual servers consume 15-25% more storage than physical servers due to multiple VM images includes those created for rollback, backup etc.

- The more concentrated and consolidated nature of server workloads in a virtual world places increasing pressure on the input/output interconnects of storage systems. I/O performance degradation can make systems unreliable.

- Heterogeneity in virtual environments (servers running on hypervisors from multiple vendors) may further drive the need for third-party storage management – i.e. storage management will need to be segregated from the virtual stack, driving additional complexity and opportunity.

- Virtual machines residing on the same physical server may require varying storage service levels.

- Desktop virtualization requires the back-end storage of every employee's desktop image, and will require unique storage management solutions.

5) **Deduplication:** A recent Gartner study suggests that approximately 70% of data is redundant and has not been accessed in more than 90 days. As a result, deduplication software is one of the most direct ways to reduce waste and complexity in storage contexts – the bidding war between NetApp and EMC for Data Domain in 2009 suggests the strategic importance of this relatively underpenetrated storage subsegment (we estimate about 20% penetration) is not lost on leading IT vendors. Deduplication software must not only reduce copies of data, but must do so intelligently, as a certain amount and type of duplicates is often required for redundancy/meeting SLAs or regulatory requirements. Today, deduplication mostly occurs on 2$^{nd}$ tier storage – we believe deduplication on primary storage is the next significant opportunity, particularly in cloud contexts where economies of scale are based on eliminating unnecessary redundancy and achieving optimal use of resources.

6) **General Data Management Tools:** This includes solutions designed for search and e-discovery of large data stores, solutions designed to add structure to unstructured data, and data management technologies designed for elastic, geographically dispersed cloud environments (these solutions will emphasize caching and data accessibility, as evidenced by VMware/SpringSource's acquisition this week of GemStone Systems).

7) **New Iterations Of Storage Management Categories:** Staple storage management software categories such as back-up and disaster recovery will need to be refreshed and re-engineered for cloud computing contexts and a world with rising server virtualization use.

**Storage Management Software Forecast And Vendor Shares**

The key trends and technology concepts we have outlined above – 1) exponential data growth (across both structured and unstructured data), 2) requirements surrounding data complexity such as compliance, 3) the increasing acceptance of public cloud concepts, 4) the impact of server virtualization and data center complexity/modernization on storage requirements, and 5) the increasing adoption of more powerful storage architectures and technologies such as scale-out storage and storage virtualization – are reflected in many areas of industry analyst firm IDC's recent storage management software market forecast.

*Archiving Software:* IDC expects archiving software to deliver a CAGR of 11.5% from 2009 to 2014, driven by pent-up challenges with information and data growth as well as consolidation projects and compliance obligations and requirements.

*Storage Management Software:* IDC expects storage management software to deliver a CAGR of 6.2% from 2009 to 2014, driven by the need to manage growing storage capacity and hybrid physical/virtual server environments.

*Storage Infrastructure Software:* IDC expects storage infrastructure software to deliver a CAGR of 4.3% from 2009 to 2014, driven by new storage architectures and storage virtualization software which enables organizations to manage storage as an aggregated pool of resources.

IDC's overall storage management forecast calls for a 2009-2014 CAGR of 6.2%.

**Worldwide Storage Software Revenue, 2005-2014 ($M)**

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|---|---|
| April 2010 forecast | 9,143 | 9,933 | 11,167 | 12,318 | 11,546 | 12,019 | 12,703 | 13,515 | 14,476 | 15,566 |
| Growth (%) | NA | 8.6 | 12.4 | 10.3 | -6.3 | 4.1 | 5.7 | 6.4 | 7.1 | 7.5 |

Source: IDC Worldwide Storage Software Revenue, 2005-2014, March 2010, Doc #222769

As one would expect of a fairly mature market, vendor market share for storage management software is relatively highly consolidated among a few large vendors – EMC (our public company spotlight this week), Symantec, IBM, NetApp, HP, CA, and Oracle (Sun). However, with architectural models in flux, we believe these vendors will be under pressure to either build or buy innovation to maintain or enhance their position and gain a larger share of future dollar flows. The market is also fertile ground for a host of private companies – these companies range across the many sub-segments of the market, from storage management for hybrid physical/virtual environments (e.g. Virsto), public cloud storage (e.g. Zetta), and backup/recovery for hybrid physical/virtual environments (e.g. Acronis). We spotlight all three companies this week in our private company segment.

**Total Storage Management Software Revenue And Market Share By Vendor, Distributed And Mainframe Systems, 2007-2008 ($MM)**

| | 2007 | 2008 | Share (%) 2007 | Share (%) 2008 | Growth (%) 2007-2008 |
|---|---|---|---|---|---|
| EMC | 2,868.3 | 2,927.7 | 26.8 | 25.2 | 2.1 |
| Symantec | 1,945.9 | 2,175.0 | 18.2 | 18.7 | 11.8 |
| IBM | 1,393.9 | 1,573.0 | 13.0 | 13.5 | 12.8 |
| NetApp | 1,127.2 | 1,299.9 | 10.5 | 11.2 | 15.3 |
| HP | 631.3 | 736.7 | 5.9 | 6.3 | 16.7 |
| CA | 452.6 | 461.9 | 4.2 | 4.0 | 2.0 |
| Sun Microsystems | 444.1 | 459.8 | 4.2 | 4.0 | 3.5 |
| Hitachi Data Systems | 403.5 | 389.8 | 3.8 | 3.4 | (3.4) |
| CommVault Systems | 171.9 | 218.1 | 1.6 | 1.9 | 26.9 |
| Brocade | 135.0 | 149.0 | 1.3 | 1.3 | 10.4 |
| BMC Software | 148.8 | 139.7 | 1.4 | 1.2 | (6.1) |
| Acronis | 85.6 | 102.9 | 0.8 | 0.9 | 20.2 |
| Double-Take Software | 78.4 | 92.3 | 0.7 | 0.8 | 17.8 |
| FalconStor | 71.8 | 81.9 | 0.7 | 0.7 | 14.1 |
| Quest | 50.2 | 56.0 | 0.5 | 0.5 | 11.7 |
| BakBone Software | 46.2 | 52.4 | 0.4 | 0.5 | 13.2 |
| Atempo | 41.0 | 43.2 | 0.4 | 0.4 | 5.3 |
| Autonomy | 33.6 | 42.0 | 0.3 | 0.4 | 25.0 |
| Syncsort | 38.8 | 40.9 | 0.4 | 0.4 | 5.4 |
| Others | 521.0 | 581.2 | 4.9 | 5.0 | 11.6 |
| **Total** | **10,689.2** | **11,623.6** | **100.0** | **100.0** | **8.7** |

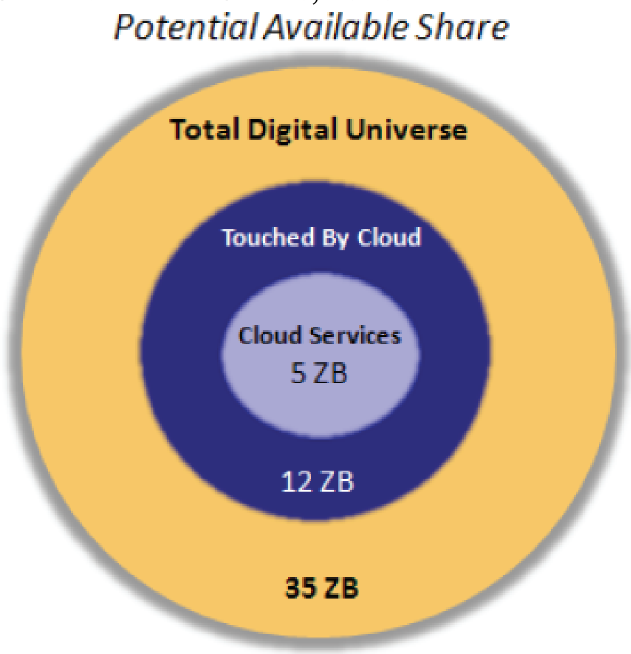
Source: Gartner

### The Public Storage Cloud: A Closer Look

We have reserved a special section for the public storage cloud at the end of this week's theme because of its importance in what we view as the ultimate reality in next-generation storage. Simply put, given the increases in data growth and complexity organizations are faced with over the next 10+ years, we believe going it alone with purely private storage infrastructures will not be the most optimal path. Large, highly automated, and elastic public clouds – ultimately tightly federated with private storage environments through high performance networks – will be able to serve a broad array of use cases and allow enterprises to seamlessly extend storage on the fly with economies of scale not achievable with purely private models. In our view, it is clear that the most straightforward path to narrowing the gap between data growth and storage capacity is to increasingly leverage the vast economies of scale of public cloud models – therefore, in concert with cloud compute services, we project rapid growth in public cloud storage services. And, since the winning storage service providers will be those that provide the most reliable, highest performance, easy to use enterprise-class solutions, significant opportunities are created again for providers of enabling storage technology. The storage software vendors poised to benefit from this trend fall into a few categories: for example, those vendors who provide the actual public cloud storage service, those who provide management and automation tools to public cloud storage providers, and those who provide federation and off-shoring functionality to enterprises seeking to integrate public cloud storage solutions into their environment.

Our view on the emergence of the public cloud model for storage is echoed by IDC – in the Digital Universe study, IDC suggests that by 2020, more than a third of the 35 trillion gigabytes (35 zettabytes) of all data will either be hosted in public or private cloud contexts or will pass through the cloud at some point of its existence.

**The Digital Universe In The Clouds, 2020**




Source: IDC, Digital Universe Study, Sponsored By EMC, May 2010

**Public Cloud Storage Evolution**

In our view, the best depiction of public cloud storage market evolution is Cloud Storage Strategy's Steve Lesem's (CEO of Mezea) cloud storage maturity model. The model contemplates both organizational adoption of cloud storage technology and development of the technology itself, and is highly consistent with our industry checks and aligns with our view of public cloud as a progression from the straightforward, low-access use cases such as backup and recovery to the ultimate potential of a seamlessly integrated enterprise-class on-demand storage solution capable of supporting most applications and computational tasks.

**Stage One**

*Adoption Drivers:* Low cost, rapid scalability, on-demand capacity, new programming capabilities
*Adopters:* SMB, developers, consumers
*Use Cases:* Testing and application development, SaaS PC backup, file sharing, rich media (photos, video, etc.), and additional device storage
*Differentiators:* SLA variability, pricing

**Stage Two**

*Adoption Drivers:* Cloud gateways (generating multi-cloud usage)
*Adopters:* Enterprise evaluators
*Use Cases:* Delivery of personal cloud storage, backup and archiving using cloud gateway (file server replacement, special use cases)
*Differentiators:* scalability and performance, access options

**Stage Three (Emergence Of Hybrid Public/Private Cloud)**

*Adoption Drivers:* Clouds become more pervasive
*Adopters:* Same as stage two
*Use Cases:* Geo access
*Differentiators:* multiple clouds versus a single cloud

In addition, in the Cloud Storage Strategy model, stage three also sees the emergence of hybrid public/private clouds. While not fully federated, hybrid cloud adoption is driven by lower average cost by mixing public/private clouds, reduction of disaster recovery and business continuity costs, the ability to optimize capex/opex mix, and improved security. The hybrid model opens up the adopter universe to enterprises with similar differentiators as above.

**Stage Four (Federated Storage Cloud)**

*Adoption Drivers:* Need for real-time dynamic interaction with partners/customers on different clouds, ability to sell excess capacity within the trust circle, optimized infrastructure utilization, establishment of trust relationships, federated authentication and provisioning across clouds, streamlining cross-cloud management, standardized APIs
*Adopters:* Enterprises, Service Providers
*Use Cases:* Full enterprise applications (e.g. supply chain management), ad-hoc capacity bursting/enhancement, on-demand hosting of sensitive as well as non-sensitive data.
*Differentiators:* Security, governance and regulatory compliance.

Source for above stages: Steve Lesem, Cloud Storage Strategy (http://www.cloudstoragestrategy.com/)

**Public Cloud Storage Trends And Forecast**

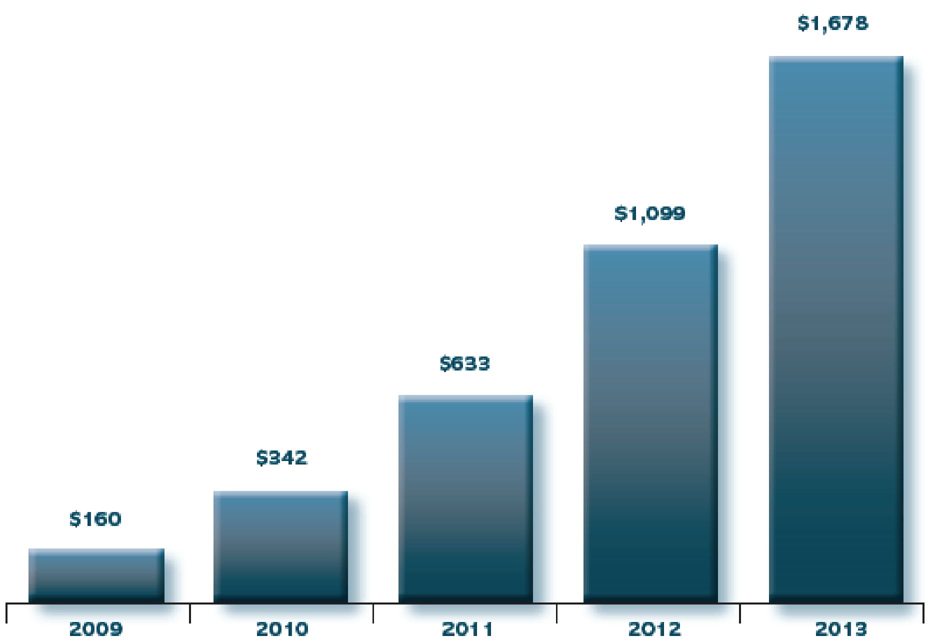
Some key market trends as identified by The 451 Group include:

- Amazon's S3 currently accounts for more than 50% of the market.
- Latency, security/privacy, integration, and standardization are key issues today. However the appeal of the cloud for certain storage use cases should drive growth – The 451 Group projects that storage will overtake compute Infrastructure-as-a-Service by 2011.
- Many cloud offerings, such as many of today's PaaS solutions, rely on scalable cloud storage as an enabling technology.
- As outlined above, public clouds require highly scalable, reliable, high-performance, and cost-efficient frameworks, and will require new storage technology models.
- Key early use case for public cloud storage is data protection and archiving, driving real demand today.
- Another potential early use case is file server replacement.
- Service providers interested in the cloud market will likely need to provide cloud storage as part of a well-rounded portfolio of cloud offerings.
- The emerging nature of the market and void in capabilities today is creating opportunity for companies ranging from startups to service providers to today's Internet and IT leaders.
- Technology driven M&A is likely.

Source: The 451 Group

Based on The 451 Group forecast, revenue generated from public cloud storage is expected to reach $1.7B in 2013 from $160MM in 2009, for a CAGR of 80%.

**Aggregate Public Cloud Storage Revenue ($MM)**




Source: The 451 Group

**Public Company Spotlight: EMC Cloud Storage Initiatives**

EMC offers a variety of infrastructure solutions and consulting services to enable companies to architect , build, and deploy scalable cloud architectures. While we do not cover EMC and do not publish an investment opinion or financial estimates on EMC shares, we provide a brief spotlight of the company this week due to the company's presence in cloud storage by virtue of its Atmos and Mozy offerings.

**Atmos**

Atmos was introduced in late 2008 and is a purpose built internal cloud storage platform with integrated hardware and software components. The software runs on commodity hardware (Intel Xeonprocessor 5500 series, a recent performance upgrade) and delivers massive scalability, distribution of content and efficiency. This enables Web 2.0/internet, service provider, telecom, government, healthcare, media and entertainment companies to deliver cloud-based services. As an example of scale-out storage architecture, Atmos is offered as an option to replace SAN/NAS storage aimed at providing petabyte levels of data for storage service providers.

It is a multi-petabyte information management solution designed to help service-provider customers automatically manage and optimize the distribution of rich, unstructured information across global and cloud storage environments. With increase in web 2.0 content and user-generated content like documents, videos, digital images and music, companies have to manage information globally. EMC delivers 'cloud optimized storage' by leveraging virtualization technologies, GeoProtect to differentiate between premium content and others, object metadata, multi-tenant, compression and dedupe features.

Key features of this product include:

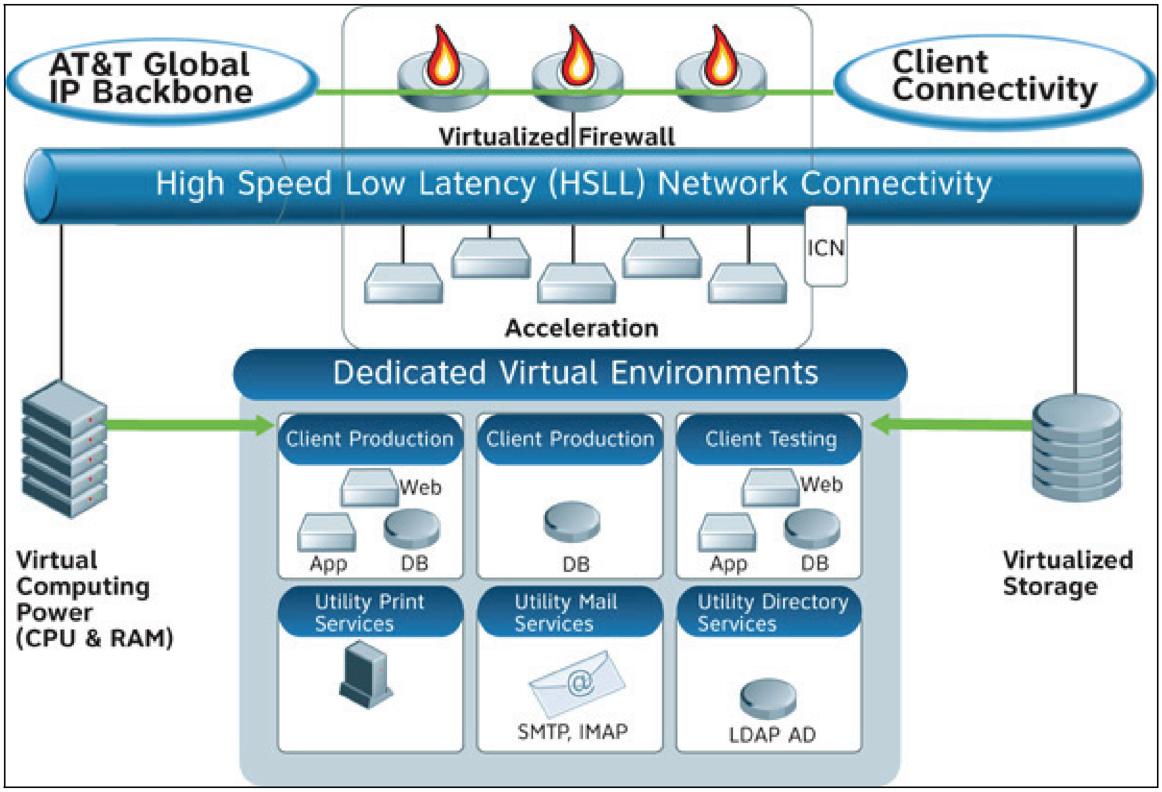
- GeoProtect is a RAID like option that splits data into multiple fragments which can be stored globally. Data can be restored is any of the fragments are lost. It offers flexibility to apply varying granular protection levels to data depending on their value. It enables replication to create multiple copies and erasure coding to distribute object segments locally or in the cloud. It is mostly used for long-term archival data retention which does not need to be accessed frequently.
- Policy-based information management - Improve operational efficiency by automatically distributing information to different geographies based on business policy.
- Object metadata – Allows tagging of content to refine content distribution, improve searches, and build custom views for cloud-based services.
- All-in-one data services – Offers built-in versioning, compression, deduplication, and spindown.
- Choice of access mechanisms – Offers both Web Service APIs for Internet-based applications or legacy protocols for file-based systems.
- Automated system management – Offers self-configuring and self-healing capabilities to reduce admin overhead.
- Multi-tenancy- Serves multiple applications securely from a single infrastructure.
- Unified namespace – Allows massive scale while operating as a single entity.

**Atmos Online**

Atmos Online is a cloud storage service built on EMC Atmos storage product at targeted at enterprise customers. It is a multi-tenant, Internet-accessible storage resource that is highly scalable and designed for various applications including cloud backup, cloud archiving, collaboration, content distribution, and medical imaging. It also enables internal to external federation where customers can federate their data from on-premise (internal) to off-premise (external) Atmos clouds thus benefiting from efficiencies of the cloud while maintaining control over the data similar to an on-premise model.

eBay and AT&T are customers of EMC Atmos. eBay uses Atmos for its cloud storage infrastructure needs and AT&T uses Atmos for its AT&T Synaptic Storage as a Service, a storage-on-demand offering for enterprise customers.

**AT&T Synaptic Hosting Infrastructure**




*Source: AT&T*

**Mozy**

Mozy, acquired by EMC in 2007 offers online backup services for consumers and SMBs. It supports laptops, desktops, servers running both Windows and Mac Oss. Key benefits include reliability, scalability, security, ease of use, and performance.

We expect additional details on EMC's cloud storage strategy during the upcoming EMC World 2010 conference to be held in Boston starting May 10.

**Private Company Spotlight: Acronis, Zetta, Virsto**

**Acronis**

Acronis provides advanced, scalable storage management and disaster recovery software that helps enterprises safeguard their information and assures the availability, security, integrity, and recoverability of their infrastructure. Acronis is the largest private storage management software vendor, and continues to deliver steady, above-category growth in our view. Acronis was founded in 2001 and has 17 locations worldwide with headquarters in Woburn, MA.

**Products**

Acronis' consumer solutions include: PC backup/restore, disk cloning and data migration, disk imaging software, partitioning software, and hard drive recovery and disk booting. For the enterprise, Acronis' solutions span: system deployment, database backup and restore, disaster recovery, data center migration, bare metal recovery, storage space reduction, virtualization solutions, and continuity planning.

In line with our theme discussion, Acronis has architected its products to mesh well with today's virtual environments. The latest version of the company's product portfolio is Acronis Backup and

Recovery 10. The latest revision is better suited for larger environments (supporting 10x more servers than the prior version – up to 3000 machines across 20 storage nodes), and includes deduplication and enhanced virtualization support. In our view, the newest release should help the company become an increasingly strategic partner, particularly for larger enterprises.

Acronis Backup & Recovery 10 includes:

- Server versions: Advanced Server, Virtual Edition, SBS Edition, Server For Windows, Server For Linux
- Acronis Backup & Recovery for workstations
- Acronis Recovery for Microsoft Exchange
- Acronis Recovery for MS SQL Server
- Acronis Disk Director 10.0
- Acronis Drive Cleanser 6.0
- Acronis Snap Deploy 3

Product benefits include:

- Minimize downtime and meet challenging RTOs
- Centralized management which improves productivity
- Storage and network savings due to data deduplication
- Simple guided automated recovery
- Automation of repetitive tasks
- Fast and easy recovery
- Granularity to recover a system or single file/folder
- A subscription based support and maintenance program

Source: Acronis

**Business/Competition**

Acronis has historically gained initial traction with SMB organizations primarily to close the emerging storage requirement/investment capacity gap by offering efficient, powerful storage management solutions at lower costs versus competitors. The company is also now gaining meaningful traction among larger enterprises, in our view (we estimate enterprises comprise around 20-25% of sales), as the company's focus on low total cost of ownership is resonating well in today's economic environment, in our view. Competitors include Symantec, IBM, CA, Double-Take, and CommVault.

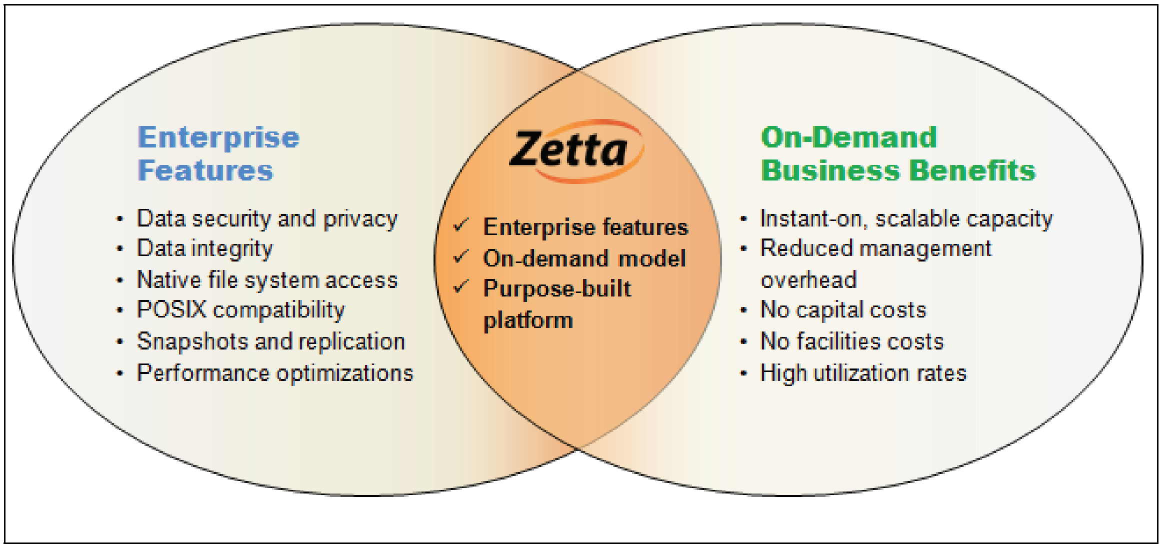
## Zetta

Zetta is one of the vendors in the emerging public cloud storage market that aims to provide enterprise-class cloud storage on-demand. Founded in 2007, the company is headquartered in Sunnyvale, CA. The company has received over $11MM in venture capital financing from Sigma Partners and Foundation Capital. Zetta targets customers in a variety of verticals with large data storage requirements including education, legal, manufacturing, rich media, technology, and financial services customers.

**Products**

As we discussed, public cloud storage can be compelling for enterprises looking for new ways to solve their data storage problems. But most cloud storage services lack the data integrity, performance, and availability guarantees needed for enterprise use cases. They also do not support standard storage access protocols to integrate with existing architectures.

Zetta's solution aims to provide an enterprise class cloud storage solution by marrying the features of an on-demand model with the needs of an enterprise.




Source: Zetta

Zetta offers services like data snapshots, replication and full redundancy, enterprise QOS guarantees, and native support for standard storage protocols to plug into existing IT architectures on a multi-tenant, on-demand storage solution. It offers scalability, availability, data protection, data integrity, security and privacy. Zetta's Virtual Storage Volume is based on a modular design and built using commodity hardware components with a software layer that enables it to scale effectively. Zetta combines smaller nodes logically into a large virtual array enabling scalable storage grid architecture. It offers RAIN6 technology for data protection, and PKI encryption.

This enables Zetta to go beyond typical cloud storage use cases like archiving and backup to support other applications include augmenting and even replacing primary Network Attached Storage (NAS) deployments, data warehousing, active archive and business continuity.

The service is priced at $0.25 per GB, per month for 1TB of capacity with minimum performance guarantees.
Key Benefits of the Zetta Solution Include:

- Rapid Time to Market: Enterprises can add storage capacity on-demand using open interfaces
- Flexibility: This instant availability and performs allowing rapid reaction to business and workload changes at minimal cost.
- Lower risk: Management of storage infrastructure is outsourced, lower risk and costs.
- Enhanced data availability and security: Zetta offers both encryption and access controls to insure data security.
- Reduced capital expense: With the pay as you go model where enterprises pay as capacity needs grow, no upfront storage hardware or management software costs are incurred.
- Reduced facility expense: In addition to lower capex costs, data center facility expenses are reduced as operational costs like space, power or cooling are not required.

**Business/Competition**

Zetta faces competition from a variety of both public and private vendors including Amazon, Iron Mountain, Microsoft, MaxiScale, Nirvanix, Isilon Systems, and NetApp. But Zetta's features like

SLA guarantees, high availability, performance, and security cover many of the cloud computing attributes we have discussed previously and hence could drive a competitive advantage. We expect demand for enterprise class cloud storage services to grow and expect Zetta to benefit from these market trends. The company is expanding into various verticals and adding new data centers. It is also building out a reseller partner channel with ISVs and targeting the mid to large enterprises.

**Virsto**

Virsto is one of vendors in the emerging cloud storage market that aims to provide efficient storage for virtual environments. Founded in 2007, the company is headquartered in Sunnyvale, CA. The company has received $7MM in venture capital financing from August Capital and Canaan Partners. The company recently released its first product, the VirstoOne storage virtualization platform for Microsoft Hyper-V environments.

Virsto targets customers in a variety of verticals with large data storage requirements including education, legal, manufacturing, rich media, technology, and financial services customers.

**Products**

Traditional physical storage techniques do not translate well in the virtual environments. Virsto aims to addresses come of unique challenges that enterprises face for virtual servers storage.

- Storage sprawl – Due to virtual machine sprawl, virtual servers consumer 15-25% more storage than physical servers due to multiple VM images includes those created for rollback, backup etc. But the majority of these images are redundant. Virsto reduces VM sprawl by reducing VM disk consumption >90%.
- Storage performance – Physical servers with multiple VMs have I/O performance degradations are unreliable. Virsto provides VM-optimized flow control to eliminate this issue called "VM I/O blender" potentially more than doubling I/O performance and enabling predictable performance and quality of service management.
- Storage management complexity – Virsto enables simple backup, thin VM storage provisioning reducing storage management complexity
- Excess storage costs – Virtualization increased storage costs while decreasing server costs. Virsto minimizes this issue by reducing the number of terabytes and disk spindles required for VM application support, enabling use of low cost commodity storage hardware, and reducing the operating expense of VM storage management.

The product is a 10MB package that has a plug-in to Microsoft Windows Server 2008 R2 Hyper-V, and offers a seamless user interface. It is a software only product and an instance of Virsto One is installed on each physical server in the data center. Virsto One in turn manages the allocation and placement of the virtual disk content on available storage devices.

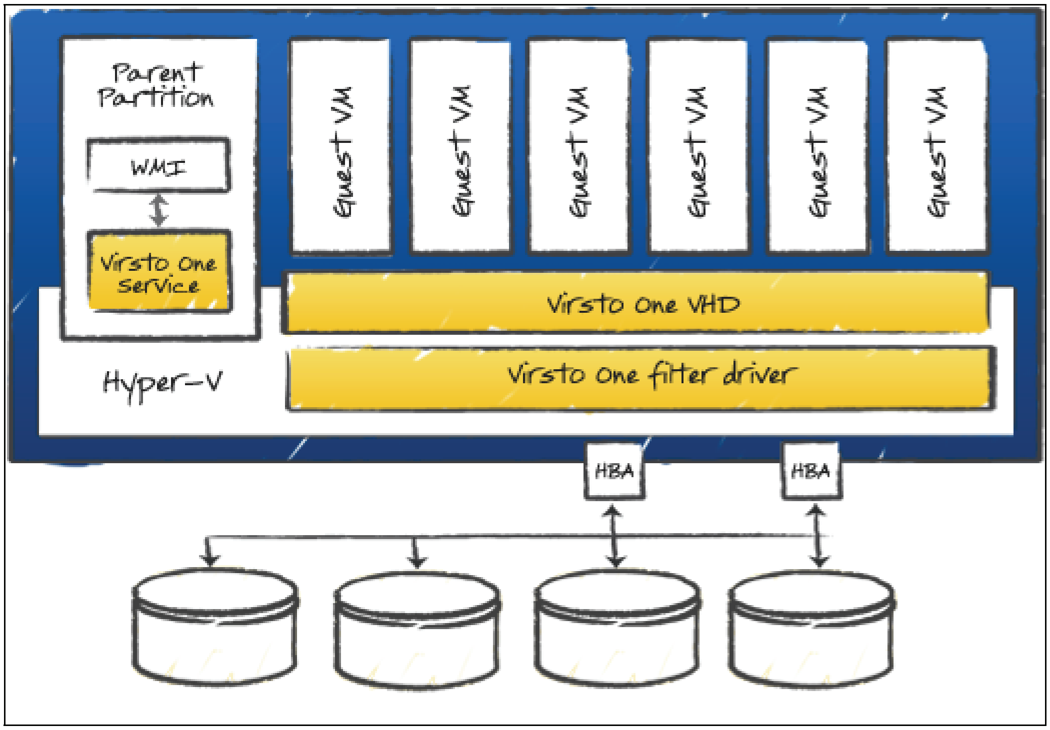
Virsto enables better performance, ability to virtualize storage-intensive workloads, maximize consolidation of server and storage hardware, reduce storage management complexity, lower storage usage and costs, and increases ability to use more commodity storage.

**Business/Competition**

Virsto competes with VMWare, HP (Lefthand Networks), Dell (EqualLogic), EMC, NetApp, Symantec, Compellent, 3PAR, EvoStor, Sanbolic, StorMagic and StarWind Software.

Virtso is one of the few companies to target the Microsoft Hyper-V market, which is a key competitive advantage. In addition the company offers easy of use, ability to work with any storage type including SCSI, iSCSI, Fibre Channel, SATA, SSD. The company is currently targeting SMBs and the Microsoft ecosystem of partners and resellers.

**Virsto Architecture**




Source: Virsto

**Enterprise Software News**

**SuccessFactors – Strong Quarter, FY10 Guidance Raised, Acquires CubeTree:** SuccessFactors reported a strong quarter with strength in bookings growth. FQ1 revenue of $43.8MM (up 24.3% Y/Y and 3.7% sequentially) was above our expectations of $43.3MM and consensus of $43.5MM and guidance of $43.3MM. EPS was $0.01 above our estimate, consensus and guidance of breakeven non-GAAP EPS. Implied bookings came in at $48.1MM, higher than our $40.6MM estimate and representing 44.7% Y/Y growth. The company issued Q2 and FY10 guidance - which was better than expected for revenue. Our estimates for F2Q10 are for non-GAAP EPS of $0.00 on $45.3MM (22.5% Y/Y) in revenue. Revenue is up from our previous estimate of $44.3MM. Our estimate for FY10 revenue is $184.4MM (20.5% Y/Y), up from $183.5MM, and non-GAAP EPS is $0.01. Our FY11 estimates are now $226.6MM (22.9% Y/Y) and EPS of $0.12, up from revenues of $224.9MM and EPS of $0.12. SuccessFactors also announced the acquisition of privately held CubeTree, Inc., a provider of enterprise social networking software for $20MM in stock plus a contingent cash payment three years from closing to bring the total consideration to $50MM. This is SuccessFactors' second acquisition in as many quarters following that of Inform last quarter. The acquisition is expected to close in FQ310. Maintain Outperform based on our continued expectations for above average revenue and bookings growth in the under-penetrated talent management and business execution strategy.

**Unica – Strong Quarter On Perpetual License Upside:** Unica reported strong FQ2 results – total revenue of $29MM (+24.5% Y/Y) was above our estimate of $28.1MM. Non-GAAP EPS was $0.08 versus our estimated $0.08. Continued sequential improvement in perpetual license revenue emerged ($7.7MM, +83% Y/Y, +40% Q/Q), as Unica's global end market continues to stabilize and more deals were closed. Continued cost discipline drove upside in operating margin. We believe Unica's end markets showed continued improvement during the quarter -- ASPs for perpetual licenses were $612K, up from $320K last quarter and above the company's historical range. The company's subscription business which includes about $600K from recent acquisitions ($6.6MM total, +49% Y/Y) also remains solid, in our view -- annual recurring contract value grew 7% Q/Q to $73MM, and we believe 40% Y/Y growth for subscriptions is achievable over H2. Unica should see a return to Y/Y growth over the full-year along with expanding profitability margins. Unica remains cautiously optimistic, and again raised the bar on perpetual license expectations by $1MM/quarter to $6MM/quarter along with a reaffirmation of subscription revenue growth expectations. Operating margin is expected to be around high single digits/low double digits over H2. Our new model contemplates higher perpetual licenses, growth in subscriptions, and continued cost management. Our FY 2010 estimates are now revenue/pro-forma EPS of $115.7MM/$0.37 ($113.3MM/$0.36 prior). Our new FY 2011 estimates are now $137MM/$0.60 ($133.6MM/$0.57 prior). Due to higher projected cash flows, we have raised our valuation range and maintain Market Perform.

**Symantec -- Solid Quarter; In Line Guidance:** Symantec reported solid FQ4 results with Non-GAAP revenues of $1.535B (+3% Y/Y, up 4.9% Q/Q, and flat Y/Y on a constant currency basis), above our revenue estimates of $1.527B and EPS of $0.40 above our estimates and consensus of $0.37. Multiple product deals were strong - approximately 49% of the over $1MM deals has both security and storage products vs. 27% in F4Q09 and 39% in F3Q10. The consumer business increased 9% Y/Y to $483MM, grew 6% adjusting for currency and grew 1% sequentially (accounting for 31% of revenue). OEM trail ware rates increased due to in-house store transition. Storage and server management business declined 1% Y/Y (1% adjusting for currency). This business saw improved results and early adoption of the new version 5.1 Storage Foundation product. Expect new product cycle to impact FY11 revenues starting with PureDisk dedupe, and BackupExec 2010 initially in the June quarter and NetBackup 7 over the longer term. F4Q growth for these new products was strong. Security and Compliance increased 2% Y/Y (24% of revenue), declined 1% adjusting for currency. DLP, endpoint management and compliance continued to see strong saw double digit growth. The SaaS hosted business saw double digit growth across geographies and market segments with particular strength in the SMB segment. Similar to FQ4, the guidance for FQ4 includes 1.5 cents of dilution due to the projected increase in OEM PC unit shipments and associated higher placement fees. Symantec continues to focus on cost control initiatives to offset the OEM fees. We are leaving our FQ1 estimates unchanged. For FQ1, we model revenue of $1.49B and EPS of $0.37. Our FY10 revenue estimate is $6.266B (prior $6.258Bn) and pro forma EPS estimate of $1.57. We are maintaining our FY12 revenue estimate of $6.57B and maintain our pro forma EPS estimate of $1.69. We maintain our Outperform rating as new product cycle and cross-selling initiatives will continue to benefit the company through FY11, in our view.

**Aspen Technology – Strong Quarter On All Fronts:** Aspen Technology provided strong financial results for FQ3 2010 based on positive business momentum and cash collection/expense management execution. FQ3 2010 revenue of $45.6MM was sharply down Y/Y (due to the new subscription model) versus our $37.5MM. Subscription revenue was $3.96MM during the quarter versus our $2.5MM, and other software revenue – which includes all non-subscription license revenue – was $14.7MM, versus our $10MM. Services and other revenue was $26.9MM, down from $30.2MM a year ago but above our $25MM estimate. Key FQ3 metrics were strong on all fronts, in our view. Solid business momentum, improvement in end markets, and strong uptake of the new aspenONE commercial model drove license bookings of $62MM (+51% Y/Y and above our $42MM estimate), despite weak historic seasonality in FQ3. Large deal flow was also positive given seasonality, with 21 bookings over $1MM (18 last Q) and 39 transactions between $250K and $1MM (57 last Q) - ASP of $807K compared favorably to last quarter's $778K. Billings backlog increased Q/Q to $270MM from $205MM. Total term contract value, which now includes some bundled maintenance from new commercial model deals also grew sequentially, based on new and expanding usage of AspenONE. Operating cash flow of $19.4MM rose significantly versus recent quarters ($9.9MM in FQ2 and loss of $5.5MM in FQ1), driven by strong billings, cash collections, and lower expenses - suggesting the normalized cash flow run rate may emerge sooner than expected following the commercial model transition. GAAP G&A dropped from 15.4MM in FQ1 to $12.6MM this quarter, and audit-only costs were down sequentially from $2.7MM to $1.5MM. FY 2010 revenue and pro-forma loss per share move to $175.1MM/($0.69), versus prior $165MM/($0.72), and FY 2011 revenue and pro-forma EPS move to $203.3MM/($0.42) vs. prior $195.3MM/($0.52). We have raised our valuation range based on improvements in cash flow and billings trends. Maintain Outperform.

# Enterprise Software
## Comparable Company Valuation

| Company | Ticker | 5/7/10 Price | YTD % chg | Enterprise Value ($Mil.) | EPS CY 2009A | EPS CY 2010E | EPS CY 2011E | Price-to-Earnings 2009E | Price-to-Earnings 2010E | Price-to-Earnings 2011E | Revenue ($Mil.) CY 2009A | Revenue ($Mil.) CY 2010E | Revenue ($Mil.) CY 2011E | Enterprise Value / Revenue CY 2009A | Enterprise Value / Revenue CY 2010E | Enterprise Value / Revenue CY 2011E | TTM | EV/FCF 2010E | EV/FCF 2011E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ***Enterprise Applications*** | | | | | | | | | | | | | | | | | | | |
| Ariba | ARBA | $13.26 | 6% | $1,012 | 0.72 | 0.79 | 0.95 | 18.3x | 16.9x | 13.9x | 342.9 | 360.7 | 395.2 | 3.0x | 2.8x | 2.6x | 16.9x | | |
| Aspen Technology | AZPN | $10.75 | 10% | $965 | (0.17) | (0.55) | (0.30) | NM | NM | NM | 225.0 | 188.4 | 222.3 | 4.3x | 5.1x | 4.3x | 35.9x | 11.9x | 11.4x |
| Blackbaud | BLKB | $22.01 | (7%) | $950 | 0.96 | 0.96 | 1.09 | 23.0x | 22.8x | 20.1x | 312.8 | 323.5 | 351.1 | 3.0x | 2.9x | 2.7x | 11.7x | 14.0x | 12.5x |
| Blackboard | BBBB | $40.19 | (11%) | $1,342 | 1.42 | 1.78 | 2.14 | 28.3x | 22.6x | 18.7x | 377.0 | 439.2 | 497.7 | 3.6x | 3.1x | 2.7x | 14.6x | | |
| Deltek | PROJ | $7.60 | (2%) | $546 | 0.58 | 0.47 | 0.54 | 13.1x | 16.0x | 14.1x | 265.8 | 266.5 | 293.6 | 2.1x | 2.0x | 1.9x | 9.9x | 8.1x | 7.5x |
| Epicor | EPIC | $9.35 | 23% | $725 | 0.52 | 0.56 | 0.65 | 18.0x | 16.8x | 14.4x | 409.6 | 425.6 | 450.4 | 1.8x | 1.7x | 1.6x | 15.3x | | |
| JDA Software | JDAS | $27.20 | 7% | $1,237 | 1.56 | 2.00 | 2.45 | 17.4x | 13.6x | 11.1x | 385.8 | 605.7 | 645.5 | 3.2x | 2.0x | 1.9x | 13.8x | | |
| Lawson | LWSN | $7.45 | 12% | $1,200 | 0.39 | 0.46 | 0.54 | 19.3x | 16.1x | 13.9x | 747.4 | 772.3 | 812.5 | 1.6x | 1.6x | 1.5x | 14.6x | | |
| Manhattan Associates | MANH | $28.94 | 20% | $527 | 0.96 | 1.20 | 1.39 | 30.1x | 24.2x | 20.9x | 246.7 | 294.9 | 321.2 | 2.1x | 1.8x | 1.6x | 9.4x | | |
| MicroStrategy | MSTR | $69.89 | (26%) | $591 | 4.92 | 4.27 | 5.61 | 14.2x | 16.4x | 12.4x | 377.8 | 417.8 | 452.0 | 1.6x | 1.4x | 1.3x | 7.6x | | |
| Netezza | NZ | $12.90 | 33% | $681 | 0.11 | 0.29 | 0.47 | NM | 45.3x | 27.6x | 190.4 | 226.9 | 274.2 | 3.6x | 3.0x | 2.5x | NM | | |
| Oracle | ORCL | $23.91 | (3%) | $119,596 | 1.50 | 1.73 | 2.00 | 15.9x | 13.8x | 11.9x | 23,320.0 | 32,548.1 | 37,589.3 | 5.1x | 3.7x | 3.2x | 14.9x | 14.7x | 12.1x |
| Progress Software | PRGS | $31.94 | 9% | $1,111 | 1.84 | 2.28 | NM | 17.4x | 14.0x | NM | 500.8 | 548.9 | 595.3 | 2.2x | 2.0x | 1.9x | 12.9x | | |
| SAP | SAP | $44.38 | (5%) | $50,481 | 2.38 | 2.80 | 3.17 | 18.6x | 15.9x | 14.0x | 14,885.9 | 14,781.1 | 15,820.9 | 3.4x | 3.4x | 3.2x | 12.6x | | |
| Sybase | SY | $40.65 | (6%) | $2,721 | 2.48 | 2.66 | 2.88 | 16.4x | 15.3x | 14.1x | 1,170.6 | 1,240.4 | 1,326.0 | 2.3x | 2.2x | 2.1x | 7.8x | | |
| Teradata | TDC | $30.19 | (4%) | $4,432 | 1.48 | 1.63 | 1.87 | 20.4x | 18.5x | 16.1x | 1,709.0 | 1,848.9 | 1,999.3 | 2.6x | 2.4x | 2.2x | 10.4x | | |
| Unica | UNCA | $9.52 | 23% | $168 | 0.12 | 0.42 | 0.60 | NM | 22.4x | 15.8x | 99.7 | 122.1 | 139.5 | 1.7x | 1.4x | 1.2x | 31.4x | 12.3x | 13.1x |
| | | | | | | | | ***19.3x*** | ***19.4x*** | ***15.9x*** | | | | ***2.8x*** | ***2.5x*** | ***2.3x*** | ***15.0x*** | ***12.2x*** | ***11.3x*** |
| ***Design/Content Management*** | | | | | | | | | | | | | | | | | | | |
| Adobe | ADBE | $32.49 | (12%) | $16,127 | 1.54 | 1.94 | 2.16 | 21.1x | 16.8x | 15.0x | 2,945.9 | 3,913.7 | 4,535.3 | 5.5x | 4.1x | 3.6x | 18.3x | 11.8x | 11.0x |
| Autodesk | ADSK | $30.56 | 20% | $16,346 | 1.07 | 1.12 | 1.42 | 28.6x | 27.2x | 21.5x | 1,763.8 | 1,809.1 | 1,984.7 | 9.3x | 9.0x | 8.2x | NM | | |
| Open Text | OTEX | $41.19 | 1% | $2,312 | 2.75 | 3.13 | NM | 15.0x | 13.1x | NM | 855.4 | 951.2 | 1,034.6 | 2.7x | 2.4x | 2.2x | 17.4x | | |
| Parametric | PMTC | $17.15 | 5% | $1,840 | 0.85 | 1.06 | NM | 20.2x | 16.2x | NM | 956.6 | 1,033.5 | NM | 1.9x | 1.8x | NM | 38.2x | | |
| | | | | | | | | ***21.2x*** | ***18.3x*** | ***18.2x*** | | | | ***4.8x*** | ***4.3x*** | ***4.7x*** | ***24.6x*** | ***11.8x*** | ***11.0x*** |
| ***On-Demand*** | | | | | | | | | | | | | | | | | | | |
| Concur | CNQR | $41.74 | (2%) | $1,980 | 0.73 | 0.82 | 1.03 | 56.9x | 51.0x | 40.6x | 258.8 | 308.2 | 373.9 | 7.6x | 6.4x | 5.3x | 32.4x | | |
| Constant Contact | CTCT | $23.00 | 44% | $538 | 0.13 | 0.35 | 0.67 | NM | 65.9x | 34.6x | 129.1 | 172.7 | 217.9 | 4.2x | 3.1x | 2.5x | NM | | |
| Keynote | KEYN | $10.10 | (7%) | $92 | 0.66 | 0.54 | NM | 15.4x | 18.9x | NM | 79.9 | 80.4 | NM | 1.2x | 1.1x | NM | NM | | |
| Phase Forward Inc | PFWD | $16.72 | 9% | $565 | 0.52 | 0.58 | 0.71 | 32.2x | 28.6x | 23.5x | 216.3 | 244.9 | 275.0 | 2.6x | 2.3x | 2.1x | NM | | |
| NetSuite | N | $15.60 | (2%) | $886 | 0.05 | 0.08 | 0.19 | NM | NM | NM | 166.5 | 184.7 | 214.3 | 5.3x | 4.8x | 4.1x | NM | | |
| Right Now | RNOW | $15.77 | (9%) | $404 | 0.39 | 0.43 | 0.67 | 40.4x | 37.0x | 23.6x | 152.7 | 178.0 | 203.7 | 2.6x | 2.3x | 2.0x | 38.5x | | |
| Salary.com | SLRY | $2.98 | 27% | $30 | (0.53) | (0.30) | NM | NM | NM | NM | 45.4 | 49.7 | NM | 0.7x | 0.6x | NM | NM | | |
| Salesforce.com | CRM | $80.90 | 10% | $9,794 | 1.10 | 1.21 | 1.51 | NM | 66.9x | 53.4x | 1,305.6 | 1,545.0 | 1,869.0 | 7.5x | 6.3x | 5.2x | 45.1x | 40.9x | 26.4x |
| SuccessFactors | SFSF | $19.84 | 20% | $1,019 | (0.04) | 0.01 | 0.12 | NM | NM | NM | 153.1 | 184.4 | 226.6 | 6.7x | 5.5x | 4.5x | NM | 27.2x | 18.2x |
| Taleo | TLEO | $23.94 | 2% | $709 | 0.77 | 0.75 | 0.94 | 31.1x | 32.0x | 25.5x | 198.4 | 230.0 | 264.3 | 3.6x | 3.1x | 2.7x | 17.1x | | |
| Vocus | VOCS | $15.82 | (12%) | $210 | 0.66 | 0.61 | 0.68 | 24.1x | 26.0x | 23.3x | 84.6 | 94.9 | 106.8 | 2.5x | 2.2x | 2.0x | 14.5x | 11.4x | 7.6x |
| | | | | | | | | ***33.3x*** | ***40.8x*** | ***32.1x*** | | | | ***4.0x*** | ***3.4x*** | ***3.4x*** | ***29.5x*** | ***26.5x*** | ***17.4x*** |
| ***Consumer/SMB*** | | | | | | | | | | | | | | | | | | | |
| Intuit | INTU | $35.21 | 15% | $11,333 | 1.85 | 2.11 | 2.21 | 19.0x | 16.7x | 15.9x | 3,240.2 | 3,460.1 | 3,774.1 | 3.5x | 3.3x | 3.0x | 13.4x | 21.8x | 17.4x |
| Microsoft | MSFT | $28.98 | (5%) | $220,252 | 1.88 | 2.18 | 2.46 | 15.4x | 13.3x | 11.8x | 60,040.6 | 64,281.1 | 69,961.8 | 3.7x | 3.4x | 3.1x | 10.9x | | |
| Real Networks | RNWK | $4.04 | 9% | $168 | (1.60) | (0.26) | (0.20) | NM | NM | NM | 562.3 | 495.4 | 541.4 | 0.3x | 0.3x | 0.3x | NM | | |
| Sonic Solutions | SNIC | $10.66 | (10%) | $269 | (1.19) | (0.01) | 0.09 | NM | NM | NM | 108.3 | 108.7 | 129.5 | 2.5x | 2.5x | 2.1x | NM | | |
| | | | | | | | | ***17.2x*** | ***15.0x*** | ***13.9x*** | | | | ***2.5x*** | ***2.4x*** | ***2.1x*** | ***12.2x*** | ***21.8x*** | ***17.4x*** |
| ***Linux*** | | | | | | | | | | | | | | | | | | | |
| Red Hat | RHAT | $28.20 | (9%) | $4,523 | 0.69 | 0.74 | 0.86 | 40.9x | 38.3x | 32.9x | 732.3 | 831.1 | 935.9 | 6.2x | 5.4x | 4.8x | 19.9x | | |
| Novell | NOVL | $5.36 | 29% | $822 | 0.33 | 0.29 | 0.30 | 16.2x | 18.6x | 17.6x | 856.8 | 831.3 | 838.8 | 1.0x | 1.0x | 1.0x | 24.8x | | |
| | | | | | | | | ***28.5x*** | ***28.4x*** | ***25.3x*** | | | | ***3.6x*** | ***3.2x*** | ***2.9x*** | ***22.4x*** | | |
| ***Infrastructure/Systems Management*** | | | | | | | | | | | | | | | | | | | |
| BMC Software | BMC | $36.85 | (8%) | $5,957 | 2.56 | 2.79 | 3.04 | 14.4x | 13.2x | 12.1x | 1,901.4 | 1,993.5 | 2,089.3 | 3.1x | 3.0x | 2.9x | 11.8x | | |
| Citrix | CTXS | $44.45 | 7% | $7,444 | 1.81 | 1.90 | 2.13 | 24.6x | 23.4x | 20.9x | 1,614.1 | 1,783.6 | 1,952.2 | 4.6x | 4.2x | 3.8x | 18.3x | | |
| CA | CA | $21.08 | (6%) | $9,775 | 1.63 | 1.79 | 1.94 | 13.0x | 11.8x | 10.9x | 4,349.9 | 4,539.9 | 4,728.9 | 2.2x | 2.2x | 2.1x | 7.5x | | |
| Compuware | CPWR | $8.01 | 11% | $1,769 | 0.58 | 0.48 | 0.55 | 13.8x | 16.9x | 14.5x | 942.4 | 927.0 | 984.2 | 1.9x | 1.9x | 1.8x | 7.2x | | |
| LogMeIn | LOGM | $21.82 | 9% | $362 | 0.59 | 0.68 | 0.64 | 37.0x | 32.3x | 33.9x | 74.4 | 92.2 | 111.2 | 4.9x | 3.9x | 3.3x | 15.2x | | |
| Quest Software | QSFT | $16.59 | (10%) | $1,146 | 1.25 | 1.30 | 1.44 | 13.3x | 12.8x | 11.5x | 695.2 | 720.8 | 757.8 | 1.6x | 1.6x | 1.5x | 8.1x | | |
| SolarWinds | SWI | $18.33 | (20%) | $1,164 | 0.63 | 0.74 | 0.97 | 29.1x | 24.7x | 19.0x | 116.5 | 161.5 | 208.9 | 10.0x | 7.2x | 5.6x | NM | | |
| Tibco | TIBX | $10.78 | 12% | $1,547 | 0.56 | 0.65 | 0.75 | 19.3x | 16.5x | 14.4x | 627.2 | 695.3 | 745.1 | 2.5x | 2.2x | 2.1x | 12.7x | | |
| VMware | VMW | $58.65 | 38% | $22,067 | 1.00 | 1.31 | 1.53 | 58.5x | 44.7x | 38.4x | 2023.94 | 2683.53 | 3281.56 | 10.9x | 8.2x | 6.7x | 25.0x | 29.2x | 17.9x |
| | | | | | | | | ***24.8x*** | ***21.8x*** | ***19.5x*** | | | | ***4.6x*** | ***3.8x*** | ***3.3x*** | ***13.2x*** | ***29.2x*** | ***17.9x*** |
| ***Security Software*** | | | | | | | | | | | | | | | | | | | |
| ArcSight | ARST | $21.79 | 148% | $677 | 0.56 | 0.64 | 0.79 | 39.0x | 34.2x | 27.7x | 165.5 | 202.6 | 240.8 | 4.1x | 3.3x | 2.8x | 17.8x | 26.6x | 24.6x |
| Blue Coat Systems | BCSI | $29.60 | 4% | $1,121 | 1.13 | 1.58 | 1.90 | 26.1x | 18.7x | 15.5x | 479.1 | 536.9 | 605.5 | 2.3x | 2.1x | 1.9x | 21.1x | | |
| Check Point | CHKP | $32.34 | (5%) | $5,720 | 2.05 | 2.31 | 2.51 | 15.8x | 14.0x | 12.9x | 924.4 | 1,039.2 | 1,127.0 | 6.2x | 5.5x | 5.1x | 10.3x | | |
| Guidance | GUID | $5.84 | 11% | $96 | (0.35) | (0.02) | 0.08 | NM | NM | 69.5x | 74.9 | 81.5 | 89.0 | 1.3x | 1.2x | 1.1x | 40.1x | | |
| McAfee | MFE | $33.01 | (19%) | $4,499 | 2.42 | 2.65 | 2.95 | 13.6x | 12.5x | 11.2x | 1,927.3 | 2,135.2 | 2,362.1 | 2.3x | 2.1x | 1.9x | 9.9x | 22.7x | 8.8x |
| SonicWALL | SNWL | $9.31 | 22% | $293 | 0.37 | 0.46 | 0.52 | 25.2x | 20.0x | 17.9x | 200.6 | 227.8 | 246.0 | 1.5x | 1.3x | 1.2x | 9.6x | | |
| SourceFire | FIRE | $19.27 | (28%) | $420 | 0.54 | 0.51 | 0.69 | 35.7x | 37.8x | 28.0x | 103.5 | 131.2 | 159.5 | 4.1x | 3.2x | 2.6x | 23.8x | | |
| Symantec | SYMC | $16.53 | (8%) | $12,365 | 1.49 | 1.55 | 1.66 | 11.1x | 10.7x | 9.9x | 5,962.0 | 6,178.5 | 6,480.9 | 2.1x | 2.0x | 1.9x | 8.7x | 7.6x | 7.1x |
| Trend Micro | TMIC | $33.48 | (12%) | $3,312 | NM | NM | NM | NM | NM | NM | NM | NM | NM | NM | NM | NM | 10.5x | | |
| Vasco Data Security | VDSI | $6.46 | 3% | $175 | 0.33 | 0.20 | 0.31 | 19.6x | 32.3x | 21.1x | 101.7 | 115.2 | 133.0 | 1.7x | 1.5x | 1.3x | 16.4x | | |
| VeriSign | VRSN | $26.35 | 9% | $3,868 | 1.28 | 1.53 | 1.76 | 20.6x | 17.2x | 14.9x | 1,030.6 | 1,090.3 | 1,204.3 | 3.8x | 3.5x | 3.2x | 11.3x | | |
| Websense | WBSN | $21.89 | 25% | $905 | 1.19 | 1.20 | 1.40 | 18.4x | 18.3x | 15.7x | 330.90 | 344.19 | 371.64 | 2.7x | 2.6x | 2.4x | 11.3x | 9.5x | 7.3x |
| | | | | | | | | ***22.5x*** | ***21.6x*** | ***22.2x*** | | | | ***2.9x*** | ***2.6x*** | ***2.3x*** | ***15.9x*** | ***16.6x*** | ***12.0x*** |
| ***HCM Companies*** | | | | | | | | | | | | | | | | | | | |
| Concur | CNQR | $41.74 | (2%) | $1,980 | 0.73 | 0.82 | 1.03 | 56.9x | 51.0x | 40.6x | 258.8 | 308.2 | 373.9 | 7.6x | 6.4x | 5.3x | 32.4x | | |
| Kenexa | KNXA | $14.61 | 12% | $269 | 0.62 | 0.59 | 0.84 | 23.6x | 24.7x | 17.3x | 157.7 | 166.9 | 183.7 | 1.7x | 1.6x | 1.5x | 13.4x | | |
| Lawson | LWSN | $7.45 | 12% | $1,200 | 0.39 | 0.46 | 0.54 | 19.3x | 16.1x | 13.9x | 747.4 | 772.3 | 812.5 | 1.6x | 1.6x | 1.5x | 14.6x | | |
| Saba Software | SABA | $4.95 | 20% | $114 | 0.26 | 0.34 | NM | 19.2x | 14.7x | NM | 105.7 | 113.6 | NM | 1.1x | 1.0x | NM | 12.6x | | |
| Salary.com | SLRY | $2.98 | 27% | $40 | (0.53) | (0.30) | NM | NM | NM | NM | 45.4 | 49.7 | NM | 0.9x | 0.8x | NM | NM | NM | NM |
| SuccessFactors | SFSF | $19.84 | 20% | $1,019 | (0.04) | $0.01 | $0.12 | NM | NM | NM | 153.1 | 184.4 | 226.6 | 6.7x | 5.5x | 4.5x | NM | 27.2x | 18.2x |
| Taleo | TLEO | $23.94 | 2% | $709 | 0.77 | 0.75 | 0.94 | 31.1x | 32.0x | 25.5x | 198.4 | 230.0 | 264.3 | 3.6x | 3.1x | 2.7x | 17.1x | | |
| Ultimate Software | ULTI | $32.41 | 10% | $768 | 0.29 | 0.49 | 0.79 | NM | 66.4x | 41.3x | 196.6 | 230.5 | 273.9 | 3.9x | 3.3x | 2.8x | 39.5x | | |
| | | | | | | | | ***30.0x*** | ***34.1x*** | ***27.7x*** | | | | ***3.4x*** | ***2.9x*** | ***3.0x*** | ***21.6x*** | ***27.2x*** | ***18.2x*** |
| S&P 500 | SP50 | 1,128 | 1% | | | | | | | | | | | | | | | | |
| Nasdaq | COMP | 2,320 | 2% | | | | | | | | | | | | | | | | |
| | | | | | | | | **23.9x** | **24.8x** | **21.5x** | | | | **3.5x** | **3.0x** | **2.8x** | **17.7x** | **18.6x** | **13.8x** |
| | | | | | | | | **19.4x** | **18.6x** | **17.3x** | | | | **2.7x** | **2.5x** | **2.5x** | **14.6x** | **14.3x** | **12.3x** |

Source: Wells Fargo Securities, LLC estimates and company reports (ADBE, ARST, AZPN, BLKB, CRM, INTU, MFE, ORCL, PROJ, SFSF, SYMC, UNCA, VMW, VOCS, WBSN), First Call consensus estimates, and FactSet.

**Upcoming Events Calendar**

| Date | Event | Location |
|---|---|---|
| May 9, 2010 | EMC World 2010 | Boston, MA |
| May 10-11, 2010 | SuccessFactors SuccessConnect User Conference | New York, NY |
| May 12-24, 2010 | Citrix Synergy 2010 | San Francisco, CA |
| May 15-19, 2010 | Unica Marketing Innovation Summit 2010 | Orlando, FL |
| May 16-19, 2010 | SAP Sapphire | Orlando, FL |
| May 16-20, 2010 | CA World | Las Vegas, NV |
| May 17-18, 2010 | SuccessFactors SuccessConnect User Conference | San Francisco, CA |
| May 17-20, 2010 | Deltek Insight 2010 User Conference | Washington, DC |
| May 24-27, 2010 | CEIC - Computer and Enterprise Investigations Conference | Las Vegas, NV |
| May 25, 2010 | McAfee Investor Forum | New York, NY |
| May 27, 2010 | Symantec Analyst Day | New York, NY |
| June 22-25, 2010 | Red Hat Summit + JBoss World 2010 | Boston, MA |
| June 28- July 1, 2010 | Gartner IT Security Summit | Washington, DC |
| July 24-29, 2010 | Black Hat US 2010 | Las Vegas, NV |
| August 2 - 5, 2010. | 2nd Annual International Conference on Cyber Security | New York, NY |
| August 15-20, 2010 | 6th Annual GFIRST National Conference | Hill Country, TX |
| August 30-September 2, 2010 | VMWorld 2010 | San Francisco, CA |
| September 7-10, 2010 | 2010 Blackbaud Conference for Nonprofits— North America | Washington, DC |
| September 29 - October 1, 2010 | 13th Annual HR Technology Conference & Exposition | Chicago, IL |
| October 18 - 21, 2010 | Symposium/ITxpo | Orlando, FL |
| October 18-22, 2010 | Interop | New York, NY |
| October 24 - 27, 2010 | Adobe MAX 2010 | Los Angeles, California |

Source: Company Information, Industry Data

# Required Disclosures

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**INTU:** Risks to our valuation include continuing macro economic weakness, SMB slowdown, retention of acquired customers, and success of new product investments.
**MFE:** Risks to our forecast include weakness in the macro economy and increased competition, weakness in the SMB segment, ability to scale.
**ORCL:** Risks to our valuation include increased competition, retention of acquired customers, failed operational synergies and saturation of the market.
**PROJ:** Risks to our valuation include slowdown in macro economic conditions, increased competition, customer concentration in the federal government contractor and architecture and engineering vertical, New Mountain Funds (NMF) overhang, and the inability to penetrate new geographies and customers.
**SFSF:** Risks to our valuation include continued weakness in the economy, increased competition, and inability to penetrate new geographies and customers.
**SYMC:** Risks to our valuation include a slowdown in macro economy, increased competition, consistent execution and success of new product investments.
**UNCA:** Risks to our valuation include increased competition, sales execution, acquisition integration and revenue concentration.
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**WBSN:** Risks to our valuation include continuing macro economy weakness, weak renewals, competition, conversion of the SurfControl customer base to the Websense platform, and the acceleration of new product upsells.

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**As of: May 7, 2010**

| | |
|---|---|
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SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE

May 7, 2010

WELLS FARGO SECURITIES

# *Equity Research*

## SRA International, Inc.

**SRX: FQ3 Essentially In-Line; Little Change To The Story/Issues**
**Fine-tuning Model Only**

**Market Perform / V**

Sector: Government Services Providers
Market Weight


- **Summary.** FQ3 revenue of $411 million and pro forma EPS of $0.29 were essentially in-line with our expectations ($400mm/$0.30). FQ3 also included several one-time items related to the struggling Era business, which is expected to continue generating operating losses for now. We are fine-tuning our EPS estimates reflecting adjustment to non-cash, non-operating items. FY10 unchanged at $1.26, FY11 to $1.40 from $1.37, and FY12 to $1.56 from $1.55. Our Valuation Range moves to $19-21 (13-14x CY11 EPS) from $17.50-19.50 to realign valuation with the government services peers. We reiterate our Market Perform rating based on valuation and lack of visible catalyst.


**Valuation Range: $19.00 to $21.00** **from $17.50 to $19.50**
We expect the shares to trade in a range of $19-21 over the next 6-12 months. This is 13-14X our CY2011 GAAP EPS estimate. Risks include ongoing losses in the Era business, the vagaries of having the U.S. federal government as a client, increasing competition especially as pursued deals get larger, large re-compete exposure in FY10, acquisition assimilation, and potential share overhang from the founder.

**Investment Thesis:**
We believe that SRA International is a leading provider of information technology (IT) and systems engineering services to the U.S. federal government. Large Civil agency and health exposure position the company well for the new Administrations priorities. Operating losses from recent acquisitions and mixed execution are likely to limit upside for the shares in the near-term.

### *Earnings Estimates Revised Up*

| | 2009A | 2010E | | 2011E | |
|---|---|---|---|---|---|
| **EPS** | | **Curr.** | **Prior** | **Curr.** | **Prior** |
| **Q1** (Sep.) | $0.27 | $0.31 A | NC | **$0.33** | **0.32** |
| **Q2** (Dec.) | 0.19 | 0.33 A | NC | **0.34** | **0.33** |
| **Q3** (Mar.) | 0.25 | **0.29 A** | **0.30** | 0.35 | NC |
| **Q4** (June) | 0.30 | 0.32 | NC | **0.38** | **0.37** |
| **FY** | $1.01 | $1.26 | NC | **$1.40** | **1.37** |
| **CY** | $1.20 | $1.28 | | $1.49 | |
| **FY P/E** | 21.0x | 16.8x | | 15.2x | |
| **Rev.(MM)** | $1,541 | $1,660 | | $1,785 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

| | |
|---|---|
| Ticker | SRX |
| Price (05/07/2010) | $21.21 |
| 52-Week Range: | $15-24 |
| Shares Outstanding: (MM) | 56.8 |
| Market Cap.: (MM) | $1,204.7 |
| S&P 500: | 1,106.61 |
| Avg. Daily Vol.: | 318,434 |
| Dividend/Yield: | $0.00/0.0% |
| LT Debt: (MM) | $0.0 |
| LT Debt/Total Cap.: | 0.0% |
| ROE: | 10.0% |
| 3-5 Yr. Est. Growth Rate: | 10.0% |
| CY 2010 Est. P/E-to-Growth: | 1.7x |
| Last Reporting Date: | 05/06/2010 After Close |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*


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**Please see page 6 for rating definitions, important disclosures and required analyst certifications**

## Company Description:

SRA is a leading provider of IT services and solutions primarily for the U.S. federal government with a focus on national security, health care and public health, and civil government.

**Revised Model Assumptions**

($ in millions, except EPS)

| | OLD FY10 | NEW FY10 | OLD FY11 | NEW FY11 | OLD FY12 | NEW FY12 |
|---|---|---|---|---|---|---|
| **Revenue** | **$1,651** | **$1,660** | **$1,785** | **$1,785** | **$1,945** | **$1,945** |
| % increase | 7% | 8% | 8% | 8% | 9% | 9% |
| **EPS (Pro forma)** | **$1.26** | **$1.26** | **$1.37** | **$1.40** | **$1.55** | **$1.56** |
| Avg. shares | 58.0 | 57.3 | 59.0 | 58.4 | 60.0 | 59.4 |
| EBITDA margin | 9.7% | 9.4% | 9.8% | 9.8% | 10.1% | 10.1% |
| Operating margin | 7.1 | 7.2 | 7.5 | 7.5 | 7.8 | 7.8 |
| Tax rate | 37.8 | NM | 39.5 | 39.5 | 39.5 | 39.5 |
| | **OLD CY10** | **NEW CY10** | | **OLD CY11** | **NEW CY11** | |
| Revenue | $1,680 | $1,689 | | $1,880 | $1,880 | |
| EPS (GAAP, Diluted) | $1.27 | $1.28 | | $1.47 | $1.49 | |

Source: Company data and Wells Fargo Securities, LLC estimates

### FQ3 Takeaways

**Revenue – Slightly Better than Expected**
- Reported revenue of $411.1 million, up 9% yr/yr. Organic growth was 8.4%.
- Our estimate was $400.0 million; Street was $407.7 million. There was no guidance.
- SRX's labor-based revenue grew 7.4% yr/yr.
- National security revenue was 51% of total revenue; Health & Civil 49%.

**EPS – Lot of Moving Parts, But We Take Pro forma to be $0.29**
- Reported GAAP EPS of $(0.70) versus $0.25 a year ago.
- Although up for debate, we are going with a pro forma EPS of $0.29.
- Our estimate (excluding 4/7 announcement of $60-70 million goodwill impairment estimate, the Era gain and tax adjustments) was $0.30, Street was $0.31. There was no guidance.
- SRX recorded Era-related goodwill impairment of $60 million (not tax deductible) and intangible impairment of $1.3 million. A cash receipt of $12.5 million resulted in gain of $3.4 million from the favorable resolution to disputes with the former owners of Era. There was also a favorable tax adjustment.
- EBITDA margin was 8.8% versus our expectation of 9.6%.
- Adjusted for the above Era-related impairment charges and gains, operating margin was 6.6% versus our expectation was 7.2%.

**Business Metrics**
- Awards were $751 million (average over the last four quarters was $633 million) for a book-to-bill of 1.8x. This included a (previously disclosed) large $500 million win. Re-compete awards were $200 million. FYTD win rate for is 73% by dollar value, and 93% for re-competes.
- Backlog was $4.76 billion up $321 million sequentially.
- Funded backlog was $922 million, or 19% of total backlog. Normal range is 18-20% of total backlog.
- Currently $2.7 billion in bids submitted and awaiting adjudication, including the ~$1.0 billion FAA bid. $318 million represents re-compete awards.

**Personnel Metrics**
- Direct labor utilization was 77.4%, up from 78.2% q/q and 77.3% yr/yr.
- Voluntary turnover in FQ3 was 11.5%, compared to 11.5% in FQ2.
- Ending headcount was 7,099, which was up 24, but had several ins-and-outs.

## Financial Highlights for the March 2010 Quarter

($ in millions, except EPS)

| | FQ3 2009A | FQ3 2010E | FQ3 2010A |
|---|---|---|---|
| Revenue | $376.9 | $400.0 | $411.0 |
| EBITDA | 34.4 | 38.4 | 36.3 |
| Operating income | 24.1 | 28.7 | (30.8) |
| Pre-tax income | 23.6 | 28.6 | (30.8) |
| Net income (GAAP) | 14.3 | 17.3 | (39.7) |
| | | | |
| EPS (GAAP, Diluted) | $0.25 | $0.30 | ($0.70) |
| EPS (Pro forma) | $0.25 | $0.30 | $0.29 |
| Average diluted shares | 57.3 | 58.1 | 56.8 |
| | | | |
| Cost of svcs/ rev | 72.9% | 75.0% | 76.1% |
| SG&A/ revenue | 17.9 | 15.4 | 15.1 |
| EBITDA margin | 9.1 | 9.6 | 8.8 |
| Operating margin | 6.4 | 7.2 | 6.6 (adj.) |
| Tax rate | 39.6 | 39.5 | NM |

Note: EBITDA excludes FAS123R expense.
Source: Company data and Wells Fargo Securities, LLC estimates

### FY10 Guidance – Little Changed

- Revenue guidance implies organic growth of 7-8% in FY10 with direct labor growth of 7-9%.
- FQ4 revenue guidance of $408-423 million, which implies organic growth of 1-5%.
- FQ4 operating margin expected at 7.2-7.8%.
- Era business is guided to have continued operating losses of $2-3 million per quarter. Given the FQ3 adjustment, the quarterly Era amortization declines by about $50,000 per quarter.
- SRX reiterated expectations for $2.2-2.5 billion in awards in FY10.
- Effective tax rate in FQ4 is expected to be 38.9%.

## Summary of Guidance Revisions

($ in millions, except EPS)

| | Our Estimate | Street Estimate | Prior Guidance | New Guidance |
|---|---|---|---|---|
| **2010E** | | | | |
| Revenue | $1,651 | $1,661 | $1,630-1,665 | $1,650-1,665 |
| EPS (GAAP) | $1.26 | $1.27 | $1.22-1.29 | not provided |
| EPS (pro forma) (a) | $1.26 | $1.27 | not provided | $1.32-1.36 |
| **FQ4E** | | | | |
| Revenue | $420 | $423 | not provided | $408-423 |
| EPS (GAAP) | $0.33 | $0.32 | not provided | $0.31-0.35 |

(a) We have included other FQ3 items in our pro forma assumption, which would lower the guidance by $0.07.
Note: pro forma EPS guidance excludes FQ3 goodwill and intangible impairment charge.
Source: Company data, Thomson ONE, and Wells Fargo Securities LLC estimates.

### Cash Flow

- FQ3 DSO was 79 days compared to 84, 76, 75 and 80 sequentially. Target is 79-81.
- FQ3 operating cash flow was $55.3 million. FYTD is $37.9 million.
- CapEx was $2.4 million, so FQ3 free cash flow was $52.9 million. FYTD is $27.8 million.
- For the year, SRX reaffirmed operating cash flow expectations of $50-65 million.

### Balance Sheet – Debt was Paid Off in FQ3

- FQ3 cash was $40.5 million compared to FQ2's $41.3 million.
- FQ3 total debt was nil compared to FQ2's $60.0 million.

**SRA International, Inc.**

**Annual Earnings Model, (June) FY2005-12E And CY2009-11E**

($ in thousands except per share amounts)

| | FY2005 (June) | FY2006 (June) | FY2007 (June) | FY2008 (June) | FY2009 (June) | FY2010E (June) | FY2011E (June) | FY2012E (June) | CY2009 (Dec) | CY2010E (Dec) | CY2011E (Dec) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Guidance: 1.65-1.665b (6-8%) | | | | | |
| **Gross Revenue** | **$881,770** | **$1,179,267** | **$1,268,872** | **$1,506,933** | **$1,540,556** | **$1,660,022** | **$1,785,000** | **$1,945,000** | **$1,609,873** | **$1,689,027** | **$1,880,000** |
| Cost of services | 653,115 | 880,802 | 954,656 | 1,121,913 | 1,123,868 | 1,256,848 | 1,335,995 | 1,451,435 | 1,198,236 | 1,271,178 | 1,404,820 |
| SG&A (excl. non-cash comp.) | 126,404 | 170,494 | 189,062 | 230,424 | 277,193 | 246,421 | 274,460 | 298,065 | 256,754 | 258,464 | 289,045 |
| Other | - | - | - | - | - | - | - | - | - | - | - |
| **EBITDA** | **102,251** | **127,971** | **125,154** | **154,596** | **139,495** | **156,753** | **174,545** | **195,500** | **154,883** | **159,385** | **186,135** |
| Depreciation and amortization | 13,141 | 18,201 | 21,187 | 25,263 | 30,021 | 28,912 | 29,750 | 30,100 | 30,214 | 29,276 | 29,900 |
| Stock option expensing (FAS 123R | - | 12,803 | 11,142 | 9,916 | 10,660 | 8,960 | 10,500 | 13,000 | 9,908 | 9,350 | 11,500 |
| Nonrecurring Items | - | - | - | - | 900 | 61,543 | - | - | 3,589 | 57,954 | - |
| Operating Income | 89,110 | 96,967 | 92,825 | 119,417 | 97,914 | 57,338 | 134,295 | 152,400 | 111,172 | 62,805 | 144,735 |
| Net Interest Income (Expense) | 3,442 | 4,232 | 6,276 | 973 | (3,243) | 354 | 400 | 600 | (566) | 409 | 500 |
| Other | - | - | 3,674 | 892 | 1,939 | - | - | - | - | - | - |
| Pretax Income | 92,552 | 101,199 | 102,775 | 121,282 | 96,610 | 57,692 | 134,695 | 153,000 | 110,606 | 63,214 | 145,235 |
| Income Tax Expense | 34,829 | 38,679 | 39,345 | 48,018 | 38,610 | 41,707 | 53,205 | 60,435 | 41,612 | 45,886 | 57,368 |
| **Net income (GAAP)** | **57,723** | **62,520** | **63,430** | **73,264** | **58,000** | **15,985** | **81,490** | **92,565** | **68,994** | **17,328** | **87,867** |
| **Back out:** | | | | | | | | | | | |
| Nonrecurring items (est.) | - | - | (2,241) | (544) | (237) | 57,254 | - | - | 400 | 56,854 | - |
| **Net income (Pro forma)** | **57,723** | **62,520** | **61,189** | **72,720** | **57,763** | **73,239** | **81,490** | **92,565** | **69,394** | **74,182** | **87,867** |
| EPS (Pro Forma, Diluted) | $1.02 | $1.08 | $1.05 | $1.23 | $1.00 | **$1.26** | $1.40 | $1.56 | $1.21 | **$1.28** | $1.49 |
| **EPS (GAAP, Diluted)** | **1.02** | **1.08** | **1.09** | **1.24** | **1.01** | 0.28 | **1.40** | **1.56** | **1.20** | 0.30 | **1.49** |
| Avg. No. Of Diluted Shares | 56,549 | 57,738 | 58,382 | 59,277 | 57,482 | 57,347 | 58,375 | 59,375 | 57,572 | 57,504 | 58,875 |
| **Yr/Yr % Increase:** | | | | | | | | | | | |
| Revenue | 43% | 34% | 8% | 19% | 2% | 8% | 8% | 9% | 6% | 5% | 11% |
| EBITDA | 42 | 25 | (2) | 24 | (10) | 12 | 11 | 12 | 8 | 3 | 17 |
| EPS (pro forma) | 43 | 6 | (3) | 17 | (18) | 25 | 11 | 12 | 13 | 6 | 17 |
| Avg. No. Of Diluted Shares | 3 | 2 | 1 | 2 | (3) | (0) | 2 | 2 | (1) | (0) | 2 |
| Cost of services/revenue | 74.1% | 74.7% | 75.2% | 74.5% | 73.0% | 75.7% | 74.8% | 74.6% | 74.4% | 75.3% | 74.7% |
| SG&A/revenue | 14.3 | 14.5 | 14.9 | 15.3 | 18.0 | 14.8 | 15.4 | 15.3 | 15.9 | 15.3 | 15.4 |
| **EBITDA margin** | **11.6** | **10.9** | **9.9** | **10.3** | **9.1** | **9.4** | **9.8** | **10.1** | **9.6** | **9.4** | **9.9** |
| Depr & amort./ revenue | 1.5 | 1.5 | 1.7 | 1.7 | 1.9 | 1.7 | 1.7 | 1.5 | 1.9 | 1.7 | 1.6 |
| Stock comp/ revenue | - | 1.1 | 0.9 | 0.7 | 0.7 | 0.5 | 0.6 | 0.7 | 0.6 | 0.6 | 0.6 |
| **Operating margin** | **10.1** | **8.2** | **7.3** | **7.9** | **6.4** | **7.2** | **7.5** | **7.8** | **6.9** | **3.7** | **7.7** |
| Tax Rate | 37.6 | 38.2 | 38.3 | 39.6 | 40.0 | 72.3 | 39.5 | 39.5 | 37.6 | 72.6 | 39.5 |

Note: Pro forma EPS exclude extraordinary/ nonrecurring gains and losses.

Figures for periods prior to FY(June) 2010 have not been restated to reflect the reclassification of certain operating costs to Cost of Services from SG&A

Source: Company data and Wells Fargo Securities, LLC estimates

**SRA International, Inc.**
**Quarterly Earnings Model, FY2009-11E**
($ in thousands except per share amounts)

| | FQ1 2009 (Sep 2008) | FQ2 2009 (Dec 2008) | FQ3 2009 (Mar 2009) | FQ4 2009 (Jun 2009) | FQ1 2010 (Sep 2009) | FQ2 2010 (Dec 2009) | FQ3 2010 (Mar 2010) | FQ4 2010E (Jun 2010) | FQ1 2011E (Sep 2010) | FQ2 2011E (Dec 2010) | FQ3 2011E (Mar 2011) | FQ4 2011E (Jun 2011) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Organic Growth Actual / Guide: | 1% | -3% | 0.7% | 3.5% | | | | | | | | |
| | | | | | | | | $408-423mm | | | | |
| **Gross Revenue** | **$392,355** | **$369,323** | **$376,928** | **$401,950** | **$417,499** | **$413,496** | **$411,027** | **$418,000** | **$430,000** | **$430,000** | **$450,000** | **$475,000** |
| Cost of services | 287,822 | 268,050 | 274,866 | 293,130 | 317,540 | 312,700 | 312,690 | 313,918 | 322,500 | 322,070 | 336,600 | 354,825 |
| SG&A (excl. non-cash comp.) | 68,512 | 71,894 | 67,640 | 69,147 | 60,362 | 59,605 | 62,082 | 64,372 | 66,220 | 65,790 | 69,300 | 73,150 |
| Other | - | - | - | - | - | - | - | - | | | | |
| **EBITDA** | **36,021** | **29,379** | **34,422** | **39,673** | **39,597** | **41,191** | **36,255** | **39,710** | **41,280** | **42,140** | **44,100** | **47,025** |
| Depreciation and amort. | 6,878 | 7,415 | 7,244 | 8,484 | 7,144 | 7,342 | 7,026 | 7,400 | 7,400 | 7,450 | 7,450 | 7,450 |
| Stock option exp. | 2,696 | 2,666 | 3,092 | 2,206 | 2,466 | 2,144 | 2,150 | 2,200 | 2,500 | 2,500 | 2,750 | 2,750 |
| Nonrecurring Items | 1,100 | (200) | - | - | - | 3,589 | 57,954 | - | - | - | - | - |
| Operating Income | 25,347 | 19,498 | 24,086 | 28,983 | 29,987 | 28,116 | (30,875) | 30,110 | 31,380 | 32,190 | 33,900 | 36,825 |
| Net Interest Inc. (Exp.) | (1,008) | (1,524) | (448) | (263) | (75) | 220 | 109 | 100 | 100 | 100 | 100 | 100 |
| Other | 1,939 | - | - | - | - | - | - | - | - | - | - | - |
| Pretax Income | 26,278 | 17,974 | 23,638 | 28,720 | 29,912 | 28,336 | (30,766) | 30,210 | 31,480 | 32,290 | 34,000 | 36,925 |
| Income Tax Expense | 10,864 | 7,144 | 9,365 | 11,237 | 11,862 | 9,148 | 8,945 | 11,752 | 12,435 | 12,755 | 13,430 | 14,585 |
| **Net income** | **15,414** | **10,830** | **14,273** | **17,483** | **18,050** | **19,188** | **(39,711)** | **18,458** | **19,045** | **19,535** | **20,570** | **22,340** |
| **Back out:** | | | | | | | | | | | | |
| Nonrecurring items (est.) | (37) | (200) | - | - | - | 400 | 56,854 | - | - | - | - | - |
| **Net income** | **15,377** | **10,630** | **14,273** | **17,483** | **18,050** | **19,588** | **17,143** | **18,458** | **19,045** | **19,535** | **20,570** | **22,340** |
| | | | FY (GAAP): | 1.01 | | | FY (Proforma): | $1.26 | | | FY (GAAP): | $1.40 |
| EPS (Pro Forma, Dil.) | $0.27 | $0.19 | $0.25 | $0.30 | $0.31 | $0.34 | **$0.29** | $0.32 | $0.33 | $0.34 | $0.35 | $0.38 |
| **EPS (GAAP, Diluted)** | **$0.27** | **$0.19** | **$0.25** | **$0.30** | **$0.31** | **$0.33** | ($0.70) | **$0.32** | **$0.33** | **$0.34** | **$0.35** | **$0.38** |
| | | | | | | | | $0.31-0.35 | | | | |
| Avg. No. Of Diluted Shares | 57,975 | 57,285 | 57,279 | 57,388 | 57,754 | 57,868 | 56,766 | 57,000 | 58,000 | 58,250 | 58,500 | 58,750 |
| **Yr/Yr % Increase:** | | | | | | | | 1-5% | << Assumed F4Q10 organic growth | | | |
| Revenue | 8% | (3%) | 0% | 4% | 6% | 12% | 9% | 4% | 3% | 4% | 9% | 14% |
| EBITDA | (5) | (24) | (10) | 0 | 10 | 40 | 5 | 0 | 4 | 2 | 22 | 18 |
| EPS (pro forma) | (15) | (39) | (18) | (2) | 18 | 82 | 17 | 6 | 5 | (1) | 20 | 17 |
| Avg. No. Of Diluted Shares | (2) | (4) | (4) | (3) | (0) | 1 | (1) | (1) | 0 | 1 | 3 | 3 |
| Cost of services/revenue | 73.4% | 72.6% | 72.9% | 72.9% | 76.1% | 75.6% | 76.1% | 75.1% | 75.0% | 74.9% | 74.8% | 74.7% |
| SG&A/revenue | 17.5 | 19.5 | 17.9 | 17.2 | 14.5 | 14.4 | 15.1 | 15.4 | 15.4 | 15.3 | 15.4 | 15.4 |
| **EBITDA margin** | **9.2** | **8.0** | **9.1** | **9.9** | **9.5** | **10.0** | **8.8** | **9.5** | **9.6** | **9.8** | **9.8** | **9.9** |
| Depr & amort./revenue | 1.8 | 2.0 | 1.9 | 2.1 | 1.7 | 1.8 | 1.7 | 1.8 | 1.7 | 1.7 | 1.7 | 1.6 |
| Stock comp/ revenue | 0.7 | 0.7 | 0.8 | 0.5 | 0.6 | 0.5 | 0.5 | 0.5 | 0.6 | 0.6 | 0.6 | 0.6 |
| **Operating margin** | **6.5** | **5.3** | **6.4** | **7.2** | **7.2** | **6.8** | **6.6** | **7.2** | **7.3** | **7.5** | **7.5** | **7.8** |
| Tax Rate | 41.3 | 39.7 | 39.6 | 39.1 | 39.7 | 32.3 | NM | 38.9 | 39.5 | 39.5 | 39.5 | 39.5 |

Note: Pro forma EPS exclude extraordinary/nonrecurring gains and losses.
Figures for periods prior to FY(June) 2010 have not been restated to reflect the reclassification of certain operating costs to Cost of Services from SG&A
Source: Company data and Wells Fargo Securities, LLC estimates

# Required Disclosures


| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 5/2/2007 | | Caso | | | |
| | 5/2/2007 | NA | 2 | 23.00 | 25.00 | 24.24 |
| ● | 8/8/2007 | NA | 2 | 24.00 | 26.00 | 23.44 |
| ● | 11/7/2007 | 27.02 | 2 | 27.00 | 30.00 | 27.02 |
| ● | 2/5/2008 | 27.16 | 2 | 27.00 | 29.00 | 27.16 |
| ● | 5/7/2008 | 23.26 | 2 | 25.00 | 27.00 | 23.26 |
| ● | 5/28/2008 | 23.01 | 2 | 22.00 | 24.00 | 23.01 |
| ● | 8/11/2008 | 23.23 | 2 | 21.00 | 23.00 | 23.23 |
| ● | 8/13/2008 | 23.00 | 2 | 20.00 | 22.00 | 23.51 |
| ● | 9/10/2008 | 23.94 | 2 | 21.00 | 23.00 | 23.77 |
| ● | 11/6/2008 | 19.09 | 2 | 17.00 | 19.00 | 13.00 |
| ● | 2/6/2009 | 16.73 | 2 | 12.00 | 14.00 | 13.67 |
| ● | 5/7/2009 | 15.54 | 2 | 15.00 | 17.00 | 15.54 |
| ● | 8/13/2009 | 19.84 | 2 | 18.00 | 20.00 | 19.77 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- ❐ Split Adjustment

**Rating Code Key**

| | | | |
|---|---|---|---|
| 1 | Outperform/Buy | SR | Suspended |
| 2 | Market Perform/Hold | NR | Not Rated |
| 3 | Underperform/Sell | NE | No Estimate |

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As of: May 7, 2010

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SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE

May 7, 2010

WELLS FARGO SECURITIES

# *Equity Research*

## Verisk Analytics, Inc.

**VRSK: Q1'10 EPS Ahead On Strong Decision Analytics**
**Adjusting '10/'11E To $1.35/$1.52 From $1.33/$1.48**

**Market Perform / V**

Sector: Financial Technology
Market Weight


- **Summary:** VRSK's Q1'10 adjusted EPS of $0.33 beat our $0.32 estimate as stronger Decision Analytics (DA) revenue/margins more than offset slightly weaker (than anticipated) Risk Assessment (RA) results. After flowing through greater strength/trends in DA, we are raising our '10/'11E EPS to $1.35/$1.52 from $1.33/$1.48. At this point, we maintain our Market Perform rating. However, given the sideways move in shares over the past several months and the core strength/predictability of the business, shares have become more attractive in light of recent volatility in the market, in our view.

- **Q1'10 Review.** Revenue of $276M (+12% reported and organic) was slightly ahead of our $274M estimate as a ~$1M shortfall in RA was more than offset by strength in mortgage and healthcare solutions in DA as well as strong transactional revenue in loss quantification (also in DA) due to severe weather during Q1'10. Adjusted EBITDA of $124M (+18%) was also $2M ahead of our estimate with actual margin of 44.8% in comparison to our 44.3% estimate. Once again, DA adjusted margins were 200 bps better than our estimate helping to offset slightly weaker margin performance (~100 bps) in DA.
- **2010 Outlook.** Our 2010 revenue/EPS estimates move to $1.152B/$1.35 from $1.143B/$1.33 due primarily to stronger anticipated performance at DA as we are slightly reducing our profitability assumptions for RA. We are now modeling revenue/adjusted EBITDA of $607M/$242M from $599M/$235M. While our RA revenue estimate remains unchanged at $545M, our adjusted EBITDA assumption moves to $265M from $269M as we now only model 30 bps of margin expansion as opposed to our previous estimate of 100 bps.
- **2011 Outlook.** Our 2011 revenue/EPS estimates move to $1.281B/$1.52 from $1.259B/$1.48 due primarily to flowing through stronger performance/trends in DA during 2010 into 2011. We now expect DA revenue of $715M (+18%) vs. our previous $697M estimate. Our adjusted EBITDA margin assumption for DA is now 40.3% vs. our previous estimate of 39.6%.

### *Earnings Estimates Revised Up*

| | 2009A | 2010E | | 2011E | |
|---|---|---|---|---|---|
| **CASH EPS** | | **Curr.** | **Prior** | **Curr.** | **Prior** |
| **Q1** (Mar.) | $0.29 | **$0.33 A** | **0.32** | **$0.37** | **0.35** |
| **Q2** (June) | 0.30 | **0.34** | **0.33** | **0.38** | **0.37** |
| **Q3** (Sep.) | 0.30 | 0.33 | NC | 0.37 | NC |
| **Q4** (Dec.) | 0.32 | **0.36** | **0.35** | **0.40** | **0.39** |
| **FY** | $1.21 | **$1.35** | **1.33** | **$1.52** | **1.48** |
| **CY** | $1.21 | $1.35 | | $1.52 | |
| **FY P/E** | 23.1x | 20.7x | | 18.4x | |
| **Rev.(MM)** | $1,027 | $1,152 | | $1,281 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

*We calculate cash earnings for VRSK by adding back the after-tax impact associated with acquisition-related intangibles, ESOP expenses and other non-recurring cash expenses.*

| | |
|---|---|
| Ticker | VRSK |
| Price (05/07/2010) | $28.00 |
| 52-Week Range: | $26-32 |
| Shares Outstanding: (MM) | 189.5 |
| Market Cap.: (MM) | $5,306.0 |
| S&P 500: | 1,120.79 |
| Avg. Daily Vol.: | 412,699 |
| Dividend/Yield: | $0.00/0.0% |
| LT Debt: (MM) | $527.0 |
| LT Debt/Total Cap.: | 94.0% |
| ROE: | NM |
| 3-5 Yr. Est. Growth Rate: | 15.0% |
| CY 2010 Est. P/CASH EPS-to-Growth: | 1.4x |
| Last Reporting Date: | 05/06/2010 After Close |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

**Valuation Range: $30.00 to $32.00**
We arrive at our valuation range of $30-$32 based on a long-term DCF model. The underlying assumptions in our model are a ten-year nominal free cash CAGR of 9% and a 3% terminal growth rate. Taking the mid-point of our valuation range ($31) implies a P/E of ~23x our 2010E EPS which compares to our universe P/E of 15-16x CY2010E EPS and a higher-quality peer group P/E of 19-20x CY2010E EPS. Risks to our valuation include the loss of a major customer due to client concentration, regulatory risk that would impede spending decisions and the cyclical nature of the insurance and mortgage related businesses.

**Investment Thesis:**
We rate shares of VRSK Market Perform due solely to valuation. Fundamentally, we believe that commanding market share, attractive secular growth opportunities and strong financial discipline and metrics create a platform that can generate attractive shareholder returns via mid-teens EPS growth driven by top line growth and margin expansion, augmented by niche acquisitions and share buyback.


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**Please see page 5 for rating definitions, important disclosures and required analyst certifications**

## Company Description:

Verisk, based in Jersey City, New Jersey, enables various industries (P&C, health and mortgage) to better understand and manage risk by providing them with proprietary data and a number of analytical tools to better predict potential losses, select and price risk, prevent and detect fraud and quantify losses.

## Summary Viewpoint

VRSK's Q1'10 adjusted EPS of $0.33 beat our $0.32 estimate as stronger Decision Analytics (DA) revenue/margins more than offset slightly weaker (than anticipated) Risk Assessment (RA) results. After flowing through greater strength/trends in DA, we are raising our '10/'11E EPS to $1.35/$1.52 from $1.33/$1.48. At this point, we maintain our Market Perform rating. **However, given the sideways move in shares over the past several months and the core strength/predictability of the business, shares have become more attractive in light off recent volatility in the market, in our view.**

## Consolidated Q1 2010 Results

Revenue of $276M (+12% reported and organic) was slightly ahead of our $274M estimate as a ~$1M shortfall in RA was more than offset by strength in mortgage and healthcare solutions in DA as well as strong transactional revenue in loss quantification (also in DA) due to severe weather during Q1'10. Adjusted EBITDA of $124M (+18%) was also $2M ahead of our estimate with actual margin of 44.8% in comparison to our 44.3% estimate. Once again, DA adjusted margins were 200 bps better than our estimate helping to offset slightly weaker margin performance (~100 bps) in DA.

| Consolidated | 2008 | Q109 | Q209 | Q309 | Q409 | 2009 | Q110 | Q210E | Q310E | Q410E | 2010E | 2011E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Revenue ($ mil) | 893.6 | 245.8 | 257.9 | 258.3 | 265.1 | 1,027.1 | 276.2 | 288.2 | 290.1 | 297.0 | 1,151.5 | 1,280.6 |
| yr/yr % | 11% | 14% | 16% | 15% | 15% | 15% | 12% | 12% | 12% | 12% | 12% | 11% |
| Adjusted EBITDA ($ mil) | 394.5 | 107.5 | 110.0 | 109.4 | 120.6 | 447.5 | 123.6 | 126.1 | 124.8 | 132.8 | 507.4 | 565.4 |
| Margin | 44.1% | 43.8% | 42.6% | 42.4% | 45.5% | 43.6% | 44.8% | 43.8% | 43.0% | 44.7% | 44.1% | 44.2% |
| yr/yr % | | 10% | 11% | 11% | 22% | 13% | 15% | 15% | 14% | 10% | 13% | 11% |
| Adjusted EPS | 1.02 | 0.29 | 0.30 | 0.30 | 0.32 | 1.21 | 0.33 | 0.34 | 0.33 | 0.36 | 1.35 | 1.52 |
| yr/yr % | | 14% | 20% | 15% | 26% | 19% | 13% | 10% | 11% | 12% | 11% | 13% |

Source: Company Reports and Wells Fargo Securities, LLC estimates

## Risk Assessment

Q1 2010 Risk Assessment (RA) revenue of $135M was up 4% in comparison to the prior year and about $1M shy of our expectation. For 2010/2011, we anticipate RA revenue of $545M (+4%)/$566M (+4%). While P&C premiums remain in a 'soft' market (-4% during 2009), VRSK continues to grow its revenue at a modest level by adding clients, penetrating existing clients with additional products and wrapping more value around its products to justify higher prices to its client base.

| Risk Assessment Revenue ($ mil) | 2008 | Q109 | Q209 | Q309 | Q409 | 2009 | Q110 | Q210E | Q310E | Q410E | 2010E | 2011E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Industry Standard Insurance Programs | 329.9 | 85.1 | 87.0 | 84.2 | 84.7 | 341.1 | 88.0 | 89.7 | 87.5 | 88.1 | 353.3 | 367.5 |
| yr/yr % | 6% | 2% | 6% | 3% | 3% | 3% | 3% | 3% | 4% | 4% | 4% | 4% |
| Property-Specific Rating/Underwriting Info | 125.8 | 32.0 | 33.9 | 33.2 | 32.9 | 132.0 | 34.0 | 35.4 | 34.9 | 34.8 | 139.0 | 144.2 |
| yr/yr % | 0% | 1% | 7% | 6% | 5% | 5% | 6% | 5% | 5% | 6% | 5% | 4% |
| Statistical Agency and Data Services | 27.5 | 7.1 | 7.1 | 7.0 | 7.5 | 28.6 | 7.2 | 7.4 | 7.2 | 7.7 | 29.5 | 30.5 |
| yr/yr % | 1% | 4% | 1% | 4% | 8% | 4% | 2% | 5% | 3% | 3% | 3% | 3% |
| Actuarial Services | 21.2 | 5.4 | 5.3 | 5.6 | 6.0 | 22.3 | 5.4 | 5.5 | 5.8 | 5.9 | 22.7 | 23.5 |
| yr/yr % | 4% | 0% | 4% | 4% | 11% | 5% | 1% | 4% | 4% | -1% | 2% | 3% |
| TOTAL | 504.4 | 129.6 | 133.3 | 130.0 | 131.1 | 524.0 | 134.6 | 138.0 | 135.5 | 136.4 | 544.5 | 565.7 |
| yr/yr % | 4% | 2% | 6% | 4% | 4% | 4% | 4% | 4% | 4% | 4% | 4% | 4% |

Source: Company Reports and Wells Fargo Securities, LLC estimates

Q1 2010 RA adjusted EBITDA of $65.5M (48.7% margin) was a bit shy of our $67.3M (49.6% margin) estimate. While our 2010 RA revenue estimate remains unchanged at $545M, our adjusted EBITDA assumption moves to $265M from $269M as we now only model 30 bps of margin expansion as opposed to our previous estimate of 100 bps. Flowing through lower margin expansion for RA in 2010/2011 results in a $277M adjusted EBITDA estimate for 2011 vs. our previous estimate of $280M.

| Risk Assessment | 2008 | Q109 | Q209 | Q309 | Q409 | 2009 | Q110 | Q210E | Q310E | Q410E | 2010E | 2011E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Revenue ($ mil) | 504.4 | 129.6 | 133.3 | 130.0 | 131.1 | 524.0 | 134.6 | 138.0 | 135.5 | 136.4 | 544.5 | 565.7 |
| yr/yr % | 4% | 2% | 6% | 4% | 4% | 4% | 4% | 4% | 4% | 4% | 4% | 4% |
| Adjusted EBITDA ($ mil) | 236.4 | 62.1 | 62.9 | 59.9 | 68.5 | 253.4 | 65.5 | 66.9 | 64.6 | 68.0 | 265.0 | 277.0 |
| Margin | 46.9% | 48.0% | 47.2% | 46.0% | 52.3% | 48.4% | 48.7% | 48.5% | 47.7% | 49.8% | 48.7% | 49.0% |
| yr/yr % | | 2% | 7% | 5% | 14% | 7% | 5% | 6% | 8% | -1% | 5% | 5% |

Source: Company Reports and Wells Fargo Securities, LLC estimates

## Decision Analytics

Q1 2010 Decision Analytics (DA) revenue of $142M was up 22% in comparison to the prior year (21% organic) and about $3M ahead of our estimate. The outperformance was driven by strength in mortgage (despite weak mortgage origination) and healthcare solutions in DA as well as strong transactional revenue in loss quantification (also in DA) due to severe weather during Q1 2010. Our outlook for top-line performance at DA has become incrementally more positive over the near and mid-term as we increasingly believe companies across all industries have moved their appetite for fraud/risk solutions/products from 'like to have' to 'must have' with the decision-making processing moving to the executive/board level and we believe VRSK has the ability to move its fraud/risk solutions/products into adjacent verticals of consumer credit (i.e. credit card and auto loans). As a result, we are increasing our 2010/2011 revenue estimates to $607M (+21%)/$715M (+18%) from $599M (+19%)/$697M (+16%).

| Decision Analytics Revenue ($ mil) | 2008 | Q109 | Q209 | Q309 | Q409 | 2009 | Q110 | Q210E | Q310E | Q410E | 2010E | 2011E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Fraud Identification and Detection Solutions | 214.0 | 63.8 | 66.6 | 69.3 | 73.3 | 273.1 | 78.8 | 80.6 | 83.9 | 86.5 | 329.8 | 391.7 |
| yr/yr % | 24% | 27% | 27% | 26% | 30% | 28% | 23% | 21% | 21% | 18% | 21% | 19% |
| Loss Prediction Solutions | 95.1 | 31.0 | 35.9 | 33.8 | 36.6 | 137.3 | 36.9 | 43.1 | 40.6 | 44.0 | 164.6 | 192.9 |
| yr/yr % | 17% | 44% | 45% | 46% | 42% | 44% | 19% | 20% | 20% | 20% | 20% | 17% |
| Loss Quantification Solutions | 80.0 | 21.4 | 22.0 | 25.2 | 24.1 | 92.7 | 25.9 | 26.4 | 30.2 | 30.1 | 112.6 | 130.3 |
| yr/yr % | 27% | 27% | 20% | 18% | 2% | 16% | 21% | 20% | 20% | 25% | 21% | 16% |
| TOTAL | 389.2 | 116.2 | 124.6 | 128.3 | 134.0 | 503.1 | 141.6 | 150.2 | 154.6 | 160.6 | 607.0 | 714.9 |
| yr/yr % | 23% | 31% | 30% | 29% | 27% | 29% | 22% | 21% | 21% | 20% | 21% | 18% |

Source: Company Reports and Wells Fargo Securities, LLC estimates

Q1 2010 DA adjusted EBITDA of $58.2M (41.1%) was nicely ahead of our $54.4M (39.2%) estimate. VRSK pointed to continual improvement in productivity in DA as the primary driver of margin expansion. As a result of stronger DA top-line, our 2010/2011 adjusted EBITDA estimates move to $242M (39.9%)/$288M (40.3%) from $235M (39.2%)/$276M (39.6%).

| Decision Analytics | 2008 | Q109 | Q209 | Q309 | Q409 | 2009 | Q110 | Q210E | Q310E | Q410E | 2010E | 2011E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Revenue ($ mil) | 389.2 | 116.2 | 124.6 | 128.3 | 134.0 | 503.1 | 141.6 | 150.2 | 154.6 | 160.6 | 607.0 | 714.9 |
| yr/yr % | 23% | 31% | 30% | 29% | 27% | 29% | 22% | 21% | 21% | 20% | 21% | 18% |
| Adjusted EBITDA ($ mil) | 158.1 | 45.4 | 47.1 | 49.5 | 52.1 | 194.1 | 58.2 | 59.2 | 60.2 | 64.9 | 242.4 | 288.4 |
| Margin | 40.6% | 39.1% | 37.8% | 38.6% | 38.8% | 38.6% | 41.1% | 39.4% | 38.9% | 40.4% | 39.9% | 40.3% |
| yr/yr % | | 23% | 16% | 20% | 32% | 23% | 28% | 26% | 21% | 25% | 25% | 19% |

Source: Company Reports and Wells Fargo Securities, LLC estimates

## Capital Allocation Remains Focused on Acquisitions

While VRSK announced a $150M buyback in conjunction with its Q1 2010 release (largely for offsetting dilution), the company indicated its acquisition pipeline remains quite active and the first priority for excess capital remains acquisitions.

**Verisk Analytics Inc. (VRSK) Earnings Model**

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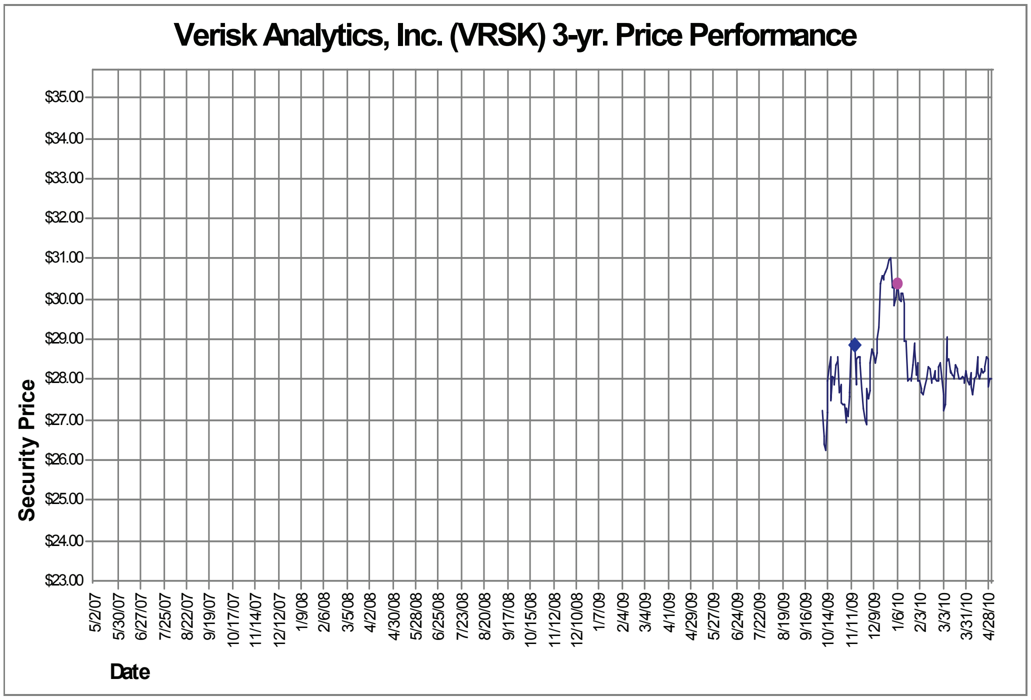
*Fiscal Year Ends December, Dollar in Millions, Except per Share Amounts*

| | 2009 | Q110 | Q210E | Q310E | Q410E | 2010E | Q111E | Q211E | Q311E | Q411E | 2011E |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **REVENUE** | | | | | | | | | | | |
| Risk Assessment | **524.0** | 134.6 | 138.0 | 135.5 | 136.4 | **544.5** | 139.6 | 143.4 | 140.8 | 141.8 | **565.7** |
| Decision Analytics | **503.1** | 141.6 | 150.2 | 154.6 | 160.6 | **607.0** | 166.5 | 177.1 | 182.3 | 189.0 | **714.9** |
| **TOTAL** | **1,027.1** | 276.2 | 288.2 | 290.1 | 297.0 | **1,151.5** | 306.1 | 320.5 | 323.1 | 330.9 | **1,280.6** |
| **EXPENSE** | | | | | | | | | | | |
| Cost of Revenue | **491.3** | 115.0 | 120.3 | 124.2 | 122.9 | **482.3** | 127.9 | 134.2 | 138.6 | 137.1 | **537.8** |
| Selling, General and Administrative | **162.6** | 37.5 | 41.8 | 41.2 | 41.3 | **161.8** | 41.0 | 45.7 | 45.3 | 45.4 | **177.4** |
| Depreciation and Amortization | **38.6** | 9.9 | 10.0 | 10.2 | 10.5 | **40.6** | 10.6 | 10.8 | 11.3 | 11.3 | **44.0** |
| Amortization of Intangibles | **32.6** | 7.3 | 7.2 | 7.2 | 7.2 | **29.0** | 7.3 | 7.4 | 7.4 | 7.5 | **29.7** |
| **TOTAL** | **725.1** | 169.7 | 179.3 | 182.8 | 181.9 | **713.7** | 186.8 | 198.1 | 202.6 | 201.4 | **788.9** |
| **OPERATING PROFIT** | **302.0** | 106.4 | 108.9 | 107.3 | 115.2 | **437.8** | 119.3 | 122.4 | 120.6 | 129.5 | **491.7** |
| **EBITDA** | **373.2** | 123.6 | 126.1 | 124.8 | 132.8 | **507.4** | 137.2 | 140.6 | 139.2 | 148.3 | **565.4** |
| **ADJUSTED EBITDA** | **447.5** | 123.6 | 126.1 | 124.8 | 132.8 | **507.4** | 137.2 | 140.6 | 139.2 | 148.3 | **565.4** |
| Investment Income and Securities Gains | **(2.1)** | 0.0 | 0.0 | 0.0 | 0.0 | **0.0** | 0.0 | 0.0 | 0.0 | 0.0 | **0.0** |
| Interest Expense | **(35.3)** | (8.5) | (8.4) | (8.2) | (8.0) | **(33.1)** | (8.0) | (8.0) | (8.0) | (8.0) | **(32.0)** |
| **PRE-TAX PROFIT** | **264.6** | 98.0 | 100.5 | 99.1 | 107.2 | **404.8** | 111.3 | 114.4 | 112.6 | 121.5 | **459.7** |
| *Effective Tax Rate* | *52.1%* | *43.5%* | *41.0%* | *41.0%* | *41.0%* | *41.6%* | *41.0%* | *41.0%* | *41.0%* | *41.0%* | *41.0%* |
| Taxes | **138.0** | 42.6 | 41.2 | 40.6 | 43.9 | **168.4** | 45.6 | 46.9 | 46.2 | 49.8 | **188.5** |
| Net Profit | **126.6** | 55.4 | 59.3 | 58.5 | 63.2 | **236.4** | 65.6 | 67.5 | 66.4 | 71.7 | **271.2** |
| Adjustments | **99.9** | 7.3 | 4.2 | 4.3 | 4.2 | **20.1** | 4.3 | 4.4 | 4.4 | 4.4 | **17.5** |
| **ADJUSTED NET PROFIT** | **221.1** | 62.0 | 63.5 | 62.8 | 67.5 | **255.8** | 70.0 | 71.9 | 70.8 | 76.1 | **288.7** |
| Diluted Shares Out | **182.2** | 189.5 | 189.6 | 189.7 | 189.8 | **189.6** | 189.5 | 189.6 | 189.6 | 189.7 | **189.6** |
| **ADJUSTED EPS** | **1.21** | 0.33 | 0.34 | 0.33 | 0.36 | **1.35** | 0.37 | 0.38 | 0.37 | 0.40 | **1.52** |
| ***as a % of Revenue*** | | | | | | | | | | | |
| Cost of Revenue | 47.8% | 41.6% | 41.7% | 42.8% | 41.4% | 41.9% | 41.8% | 41.9% | 42.9% | 41.4% | 42.0% |
| Selling, General and Administrative | 15.8% | 13.6% | 14.5% | 14.2% | 13.9% | 14.1% | 13.4% | 14.3% | 14.0% | 13.7% | 13.9% |
| Depreciation and Amortization | 3.8% | 3.6% | 3.5% | 3.5% | 3.5% | 3.5% | 3.5% | 3.4% | 3.5% | 3.4% | 3.4% |
| Amortization of Intangibles | 3.2% | 2.6% | 2.5% | 2.5% | 2.4% | 2.5% | 2.4% | 2.3% | 2.3% | 2.3% | 2.3% |
| Adjusted EBITDA | 43.6% | 44.8% | 43.8% | 43.0% | 44.7% | 44.1% | 44.8% | 43.9% | 43.1% | 44.8% | 44.2% |
| ***Growth Analysis*** | | | | | | | | | | | |
| Risk Assessment | 3.9% | 3.9% | 3.5% | 4.2% | 4.1% | 3.9% | 3.7% | 4.0% | 4.0% | 4.0% | 3.9% |
| Decision Analytics | 29.3% | 21.9% | 20.5% | 20.5% | 19.8% | 20.6% | 17.6% | 17.9% | 17.9% | 17.7% | 17.8% |
| Total Revenue | 14.9% | 12.4% | 11.7% | 12.3% | 12.0% | 12.1% | 10.8% | 11.2% | 11.4% | 11.4% | 11.2% |
| Adjusted EBITDA | 13.4% | 15.0% | 14.6% | 14.1% | 10.2% | 13.4% | 11.0% | 11.5% | 11.6% | 11.7% | 11.4% |
| Adjusted EPS | 18.7% | 12.6% | 9.9% | 10.5% | 11.9% | 11.2% | 12.8% | 13.1% | 12.9% | 12.8% | 12.9% |

*Source: Wells Fargo Securities, LLC estimates and Company Reports*

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 11/16/2009 | | Willi | | | |
| ◆ | 11/16/2009 | 28.90 | 2 | 29.00 | 31.00 | 28.85 |
| ● | 1/7/2010 | 30.44 | 2 | 30.00 | 32.00 | 30.39 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- ☐ Split Adjustment

**Rating Code Key**

| | | | |
|---|---|---|---|
| 1 | Outperform/Buy | SR | Suspended |
| 2 | Market Perform/Hold | NR | Not Rated |
| 3 | Underperform/Sell | NE | No Estimate |

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**VRSK:** Risks to our valuation include the loss of a major customer due to client concentration, regulatory risk that would impede spending decisions and the cyclical nature of the insurance and mortgage related businesses.

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**M=Market Weight:** Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.

**U=Underweight:** Industry expected to underperform the relevant broad market benchmark over the next 12 months.

**VOLATILITY RATING**

**V** = A stock is defined as volatile if the stock price has fluctuated by +/-20% or greater in at least 8 of the past 24 months or if the analyst expects significant volatility. All IPO stocks are automatically rated volatile within the first 24 months of trading.

As of: May 7, 2010

| | |
|---|---|
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May 7, 2010

WELLS FARGO SECURITIES

# *Equity Research*

## Warner Chilcott Ltd.

**WCRX: 1Q Slight Beat But Revenue Missed, Raising Estimates**
**Maintain Outperform -- But Will Need Patience**

**Outperform / V**

Sector: Specialty Drugs
Market Weight


- **Summary.** Maintain Outperform rating on WCRX. Valuation appears attractive at 7.3x our 2010 cash EPS estimate. Raised 2010E cash EPS to $3.34 from $3.32. Introducing 2011E cash EPS of $3.70. Management reiterated 2010 EPS guidance of $3.30 - $3.40. Lowering valuation range to $28 - $30 (8.5-9x 2010 cash EPS) from $30-33. While shares are attractively valued, execution risks remain and the 1Q 2010 revenue miss suggests WCRX may take a while to regain investor confidence.


- **Maintain Outperform.** While we believe the near-term could be choppy, we continue to maintain our Outperform rating on WCRX. Our rating is based on our belief that a re-configured sales force could curb the slide in Actonel prescriptions, the Asacol franchise will continue to successfully transition to the HD formulation, and attractive valuation (7.3x our 2010 cash EPS estimate of $3.34, vs. peer group of 12-13x).

- **We are raising our 2010 cash EPS estimate to $3.34 from $3.32.** The change primarily reflects a higher gross margin (lower COGS), partially offset by higher SG&A expenses. We are also introducing our 2011 cash EPS estimate of $3.70. Management reiterated 2010 EPS guidance of $3.30 - $3.40, while changing several other metrics. Please see Exhibit 2 for more details.

- **Key takeaways:** 1) Actonel — TRx in the US declined 21.6% yoy. However, the decline appears to be decelerating (-24.2% in 2009). The PDUFA date for next-generation Actonel is July 2010; 2) Asacol — transition to the HD formulation (800mg) remains a work-in-progress with encouraging recent TRx trends; and 3) Doryx — the 150mg strength represented over 90% of franchise prescriptions. Reported revenue was below Rx demand trend due to contraction of trade inventory level.

- **WCRX reported adjusted 1Q EPS of $0.88 on revenue of $688.6MM.** This compares to our estimates of $0.96 and $739.9MM. Consensus estimates were $0.86 and $764.8MM. The revenue miss was driven by lower than expected results for Actonel (the international segment; $108.5MM A vs. our $132.2MM E), Doryx ($50.9MM A vs. our $64.2MM E), and other revenues ($43.8MM A vs. our $55.8MM E). SG&A came in ~$43MM above our $277.3MM estimate, while R&D was ~$6.8MM below our estimate.

### *Earnings Estimates Revised Up*

| | 2009A | 2010E | | 2011E | |
|---|---|---|---|---|---|
| **CASH EPS** | | **Curr.** | **Prior** | **Curr.** | **Prior** |
| **Q1** (Mar.) | $0.39 | **$0.88 A** | **0.96** | NE | |
| **Q2** (June) | 0.44 | **0.77** | **0.85** | NE | |
| **Q3** (Sep.) | 0.41 | **0.90** | **0.78** | NE | |
| **Q4** (Dec.) | 0.63 | **0.91** | **0.74** | NE | |
| **FY** | $1.87 | **$3.34** | **3.32** | $3.70 | |
| **CY** | $1.87 | $3.34 | | $3.70 | |
| **FY P/E** | 13.1x | 7.3x | | 6.6x | |
| **Rev.(MM)** | $1,354 | $2,902 | | $3,119 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

*[1]Cash EPS = Adjusted EPS + tax-effected amortizationof intangibles and deferred financing costs. 2010 quarterly EPS do not sum to full year due to rounding.*

| | |
|---|---|
| Ticker | WCRX |
| Price (05/07/2010) | $24.51 |
| 52-Week Range: | $10-30 |
| Shares Outstanding: (MM) | 252.5 |
| Market Cap.: (MM) | $6,188.8 |
| S&P 500: | 1,117.58 |
| Avg. Daily Vol.: | 1,593,990 |
| Dividend/Yield: | $0.00/0.0% |
| LT Debt: (MM) | $2,830.5 |
| LT Debt/Total Cap.: | 60.0% |
| ROE: | 33.0% |
| 3-5 Yr. Est. Growth Rate: | 15.0% |
| CY 2010 Est. P/CASH EPS-to-Growth: | 0.5x |
| Last Reporting Date: | 05/07/2010 Before Open |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

**Valuation Range: $28.00 to $30.00** **from $30.00 to $33.00**
We believe the stock could trade in the $28-30 range in the next 12 months, based on a P/E multiple of 8-9.5.x our 2010 cash EPS estimate of $3.34. Risks to the stock trading to our valuation range include the inability to integrate PGP effectively and deceleration in core product growth.

**Investment Thesis:**
We rate the shares of WCRX Outperform. Growth potential offered by the recent acquisition of P&G's pharmaceutical business underlies our enthusiasm.


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**Please see page 6 for rating definitions, important disclosures and required analyst certifications**

## Company Description:

WCRX is a specialty pharmaceutical company focused on developing, manufacturing, and marketing of branded prescription pharmaceutical products in women's healthcare and dermatology in the United States.

**Maintain Outperform.** While we believe the near-term could be choppy, we continue to maintain our Outperform rating on WCRX shares. Our rating is based on our belief that a re-configured sales force could curb the slide in Actonel prescriptions, the Asacol franchise will continue to successfully transition to the HD formulation, and attractive valuation (7.3x our 2010 cash EPS estimate of $3.34, vs. peer group of 12-13x).

In our view, the discounted valuation reflects investor concerns regarding WCRX's earnings growth profile and the threat to the Asacol franchise, without giving consideration to the potential of a successful Asacol HD transition (which is ongoing), continued growth of Loestrin-24, and additional support from possible approval and launch of WC-3016 and second-generation Actonel (longer-term). That said, we concede that execution risks remain. Therefore, we caution that WCRX shares may trade sideways until further evidence of Actonel stabilization and Asacol HD transition emerges. Furthermore, given the revenue miss in 1Q, WCRX will need to demonstrate an accelerating revenue trend to regain investor confidence, in our view.

**We are raising our 2010 cash EPS estimate to $3.34 from $3.32.** The change primarily reflects a higher gross margin (lower COGS), partially offset by higher SG&A expenses. We are also introducing our 2011 cash EPS estimate of $3.70.

Management reiterated 2010 EPS guidance of $3.30 - $3.40, while changing several other metrics. Please see Exhibit 2 for more details.

**Exhibit 1. Current vs. Prior Estimates**

| ($MM except EPS) | Current 2010 Estimate | Previous 2010 Estimate | Current 2011 Estimate |
|---|---|---|---|
| Oral Contraceptives | 421.4 | 375.7 | 542.6 |
| Hormone Replacement | 189.6 | 198.9 | 203.9 |
| Psoriasis | 0.0 | 0.0 | 0.0 |
| Acne | 245.9 | 267.8 | 298.2 |
| Gastroenterology | 752.8 | 693.3 | 884.4 |
| Osteoporosis | 1,002.3 | 1,045.9 | 870.7 |
| Urology | 86.7 | 89.8 | 97.4 |
| Other/contract | 203.6 | 232.2 | 222.0 |
| Total revenue | 2,902.3 | 2,903.5 | 3,119.1 |
| R&D | 182.6 | 185.8 | 191.7 |
| SG&A | 1,239.4 | 1,211.4 | 1,294.8 |
| "Cash" Net Income | 849.2 | 847.8 | 946.7 |
| "Cash" EPS | $3.34 | $3.32 | $3.70 |

Source: Wells Fargo Securities, LLC estimates

**Exhibit 2. Management Guidance – FY 2010** ($MM, except per share data)

| Release Date | January 2010 | 1Q 2010 |
|---|---|---|
| **Revenue** | $2,900-$2,950 | $2,900-$2,950 |
| **Gross Margin** | 88%-89% | 89%-90% |
| **SG&A** | $1,200-$1,250 | $1,200-$1,250 |
| **R&D** | $180-$200 | $180-$200 |
| **Amortization** | $641 | $641 |
| **Tax Provision (EBTA)** | 9%-10% | 12%-13% |
| **Adjusted Net Income** | $190-$215 | $180-$205 |
| **Cash Net Income** | $842-$867 | $842-$867 |
| **Cash EPS** | $3.30-$3.40 | $3.30-$3.40 |

Source: Company Reports

**1Q 2010 Key Product Takeaways:**

- Actonel — TRx in the US declined 21.6% year-over-year. However, the decline appears to be decelerating (-24.2% in 2009). Management acknowledged that yr/yr comparisons of Actonel TRx may remain challenging, due to a reduced sales force footprint (currently at 120 reps, expanding to 400 reps by 2H 2010). The PDUFA date for next-generation Actonel is July 2010. WCRX indicated FDA may want to see some additional safety (biopsy) data, suggesting to us a low likelihood of first cycle approval. We note this is not surprising – management had previously guided to a late 2010 or early 2011 launch.
- Asacol — Transition to the HD formulation (800mg) remains a work-in-progress. However, we note the recent prescription trend has been encouraging, with HD reaching 11.5% franchise NRx in March, up from 7.5% in December.
- Doryx — The 150mg strength represented over 90% of franchise prescriptions. Reported revenue was below Rx demand trend due to contraction of trade inventory level.

**WCRX reported adjusted 1Q EPS of $0.88 on revenue of $688.6 million**. This compares to our estimates of $0.96 and $739.9 million. Consensus estimates were $0.86 and $764.8 million. The revenue miss was driven by lower than expected results for Actonel (the international segment; $108.5MM A vs. our $132.2MM E), Doryx ($50.9MM A vs. our $64.2MM E), and other revenues ($43.8MM A vs. our $55.8MM E). SG&A came in ~$43 million above our $277.3 million estimate, while R&D was ~$6.8 million below our estimate.

Cash EPS exclude:

- $105.5 million write-off of acquired inventories,
- $25.1 million gain on the sale of certain inventories associated with the LEO products,
- $72.7 million of revenue and $73.0 million COGS from the LEO distribution agreement.

We note, in accordance with management guidance, we are now including severance costs and acquisition expenses in our SG&A estimates. Severance costs and acquisition expenses in 1Q 2010 were $12.5 million and $11.5 million, respectively.

**Exhibit 3. 1Q 2010 Actual Results vs. Estimates**

| | Reported Actual | Our Estimate | Actual vs. Estimate |
|---|---|---|---|
| Revenue ($MM) | 688.6 | 739.9 | (51.3) |
| *yr/yr growth* | 179.9% | 200.8% | |
| Gross Margin | 90.7% | 88.0% | 2.7% |
| R&D ($MM) | 31.1 | 37.9 | (6.8) |
| *yr/yr growth* | 30.5% | 58.9% | |
| SG&A ($MM) | 320.1 | 277.3 | 42.8 |
| *yr/yr growth* | 584.0% | 492.6% | |
| Operating Income ($MM) | 112.4 | 174.1 | (61.7) |
| Operating Margin | 16.3% | 23.5% | (7.2%) |
| Tax rate | 11.4% | 12.4% | (1.0%) |
| "Cash" Net Income ($MM) | 223.0 | 243.8 | (20.8) |
| *yr/yr growth* | 128.3% | 149.6% | |
| "Cash" Net Margin | 32.4% | 32.9% | (0.6%) |
| "Cash" EPS ($) | 0.88 | 0.96 | (0.07) |

Source: Company Reports and Wells Fargo Securities, LLC estimates

## Exhibit 4. 1Q 2010 Segment Results vs. Estimates ($MM)

| | Reported Actual | Our Estimate | Actual vs. Estimate |
|---|---|---|---|
| Oral Contraceptives | 96.8 | 92.0 | 4.8 |
| *yr/yr growth* | 32.4% | 25.8% | |
| Hormone Replacement | 46.5 | 50.5 | (4.0) |
| *yr/yr growth* | 10.2% | 19.7% | |
| Acne | 50.9 | 64.2 | (13.3) |
| *yr/yr growth* | 1.0% | 27.3% | |
| Gastroenterology | 165.0 | 167.4 | (2.4) |
| Osteoporosis | 262.3 | 284.2 | (21.9) |
| Urology | 18.2 | 22.2 | |
| Other | 43.8 | 55.8 | (12.0) |
| *yr/yr growth* | 265.0% | 365.0% | |
| Contract | 5.1 | 3.7 | 1.4 |
| *yr/yr growth* | 37.8% | 0.0% | |

Source: Company Reports and Wells Fargo Securities, LLC estimates

## Exhibit 5. WCRX Reporting History

| | CY2008 | | | | CY2009 | | | | CY2010 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **$MM except EPS** | **Q1** | **Q2** | **Q3** | **Q4** | **Q1** | **Q2** | **Q3** | **Q4** | **Q1** | **Q2** | **Q3** | **Q4** |
| Revenue | 229.5 | 234.2 | 231.9 | 242.5 | 246.0 | 250.8 | 252.8 | 604.1 | 688.6 | | | |
| Gross Profit | 181.7 | 183.2 | 185.1 | 189.3 | 197.3 | 203.8 | 208.4 | 540.0 | 624.6 | | | |
| R&D | 12.2 | 12.5 | 10.0 | 15.2 | 23.9 | 11.9 | 11.6 | 29.3 | 31.1 | | | |
| SG&A | 55.2 | 47.1 | 45.9 | 44.4 | 46.8 | 53.0 | 59.1 | 277.5 | 320.1 | | | |
| Operating Income | 61.7 | 70.4 | 70.1 | 70.6 | 69.6 | 81.9 | 90.7 | 92.0 | 112.4 | | | |
| Cash Net Income | 82.9 | 84.3 | 96.5 | 100.5 | 97.7 | 109.2 | 103.2 | 159.9 | 223.0 | | | |
| Cash EPS | $0.33 | $0.34 | $0.39 | $0.40 | $0.39 | $0.44 | $0.41 | $0.63 | $0.88 | | | |
| **% Revenue** | | | | | | | | | | | | |
| Gross Margin | 79.2% | 78.2% | 79.8% | 78.1% | 80.2% | 81.3% | 82.5% | 89.4% | 90.7% | | | |
| R&D | 5.3% | 5.4% | 4.3% | 6.3% | 9.7% | 4.8% | 4.6% | 4.8% | 4.5% | | | |
| SG&A | 24.1% | 20.1% | 19.8% | 18.3% | 19.0% | 21.1% | 23.4% | 45.9% | 46.5% | | | |
| Operating Income | 26.9% | 30.1% | 30.2% | 29.1% | 28.3% | 32.6% | 35.9% | 15.2% | 16.3% | | | |
| Cash Net Income | 36.1% | 36.0% | 41.6% | 41.4% | 39.7% | 43.5% | 40.8% | 26.5% | 32.4% | | | |
| **Yr/yr growth** | | | | | | | | | | | | |
| Revenue | +5.1% | +7.2% | +2.2% | +7.1% | +7.2% | +7.1% | +9.0% | +149.1% | +179.9% | | | |
| Gross Profit | +8.3% | +9.2% | +2.4% | +4.6% | +8.5% | +11.3% | +12.6% | +185.2% | +216.7% | | | |
| R&D | +64.6% | +69.5% | -10.7% | -36.8% | +96.0% | -4.8% | +16.3% | +92.3% | +30.3% | | | |
| SG&A | -21.6% | -33.1% | -23.8% | -27.0% | -15.2% | +12.6% | +28.8% | +525.0% | +584.0% | | | |
| Operating Income | +147.9% | +182.8% | +67.7% | +80.8% | +12.7% | +16.3% | +29.4% | +30.3% | +61.5% | | | |
| Cash Net Income | +42.2% | +44.5% | +29.5% | +45.0% | +17.8% | +29.6% | +6.9% | +59.2% | +128.3% | | | |
| Cash EPS | +43.8% | +46.0% | +28.4% | +44.9% | +17.8% | +29.7% | +6.5% | +57.1% | +125.7% | | | |

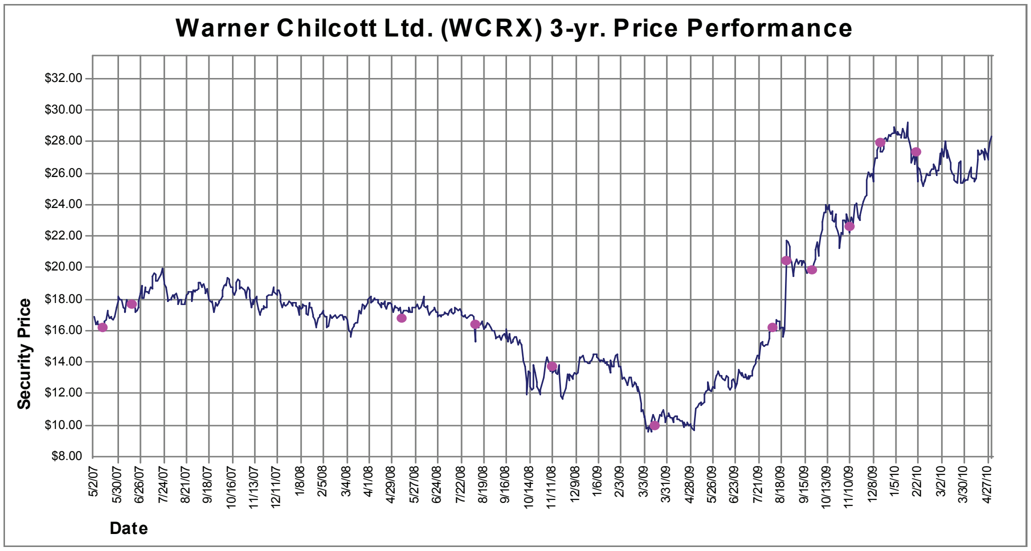
Source: Company Reports and Wells Fargo Securities, LLC estimates

**Warner Chilcott Limited Financial Model**

| ($MM except per share data) | FY2007A | FY2008A | Q1 | Q2 | Q3 | Q4 | FY2009A | Q1 | Q2E | Q3E | Q4E | FY2010E | FY2011E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **REVENUE** | | | | | | | | | | | | | |
| **Oral Contraceptives** | **$266.9** | **$276.6** | **$73.1** | **$75.5** | **$82.7** | **$89.4** | **$320.7** | **$96.8** | **$101.4** | **$111.0** | **$112.2** | **$421.4** | **$542.6** |
| *Yr/Yr change* | *16.8%* | *3.6%* | *12.4%* | *5.8%* | *19.0%* | *26.4%* | *15.9%* | *32.4%* | *34.3%* | *34.2%* | *25.5%* | *31.4%* | *28.8%* |
| **Hormone Replacement Therapy** | **$165.9** | **$171.0** | **$42.2** | **$47.4** | **$57.0** | **$56.4** | **$203.0** | **$46.5** | **$48.0** | **$47.1** | **$48.0** | **$189.6** | **$203.9** |
| *Yr/Yr change* | *13.1%* | *3.1%* | *1.3%* | *9.0%* | *38.1%* | *26.5%* | *18.7%* | *10.2%* | *1.3%* | *-17.4%* | *-15.0%* | *-6.6%* | *7.6%* |
| **Psoriasis** | **$272.5** | **$276.7** | **$64.6** | **$70.4** | **$52.8** | | **$187.8** | | | | | | |
| *Yr/Yr change* | *31.6%* | *1.5%* | *-7.7%* | *-2.6%* | *-18.2%* | | *-32.1%* | | | | | | |
| **Acne** | **$115.8** | **$158.9** | **$50.4** | **$44.9** | **$48.2** | **$66.6** | **$210.1** | **$50.9** | **$61.5** | **$63.7** | **$69.8** | **$245.9** | **$298.2** |
| *Yr/Yr change* | *13.1%* | *37.2%* | *43.5%* | *41.6%* | *7.7%* | *40.8%* | *32.2%* | *1.0%* | *37.0%* | *32.2%* | *4.8%* | *17.1%* | |
| **Gastroenterology** | | | | | | **$114.9** | **$114.9** | **$165.0** | **$184.3** | **$197.6** | **$205.9** | **$752.8** | **$884.4** |
| *Yr/Yr change* | | | | | | | | | | | | | |
| **Osteoporosis** | | | | | | **$222.0** | **$222.0** | **$262.3** | **$252.6** | **$252.1** | **$235.3** | **$1,002.3** | **$870.7** |
| *Yr/Yr change* | | | | | | | | | | | | | |
| **Urology** | | | | | | **$14.9** | **$14.9** | **$18.2** | **$22.8** | **$22.8** | **$22.8** | **$86.7** | **$97.4** |
| *Yr/Yr change* | | | | | | | | | | | | | |
| **Other** | **$52.9** | **$36.2** | **$12.0** | **$10.1** | **$9.1** | **$36.2** | **$67.4** | **$43.8** | **$45.1** | **$46.5** | **$47.9** | **$183.2** | **$201.6** |
| **Contract Manufacture** | **$25.7** | **$18.7** | **$3.7** | **$2.5** | **$3.0** | **$3.7** | **$12.9** | **$5.1** | **$5.1** | **$5.1** | **$5.1** | **$20.4** | **$20.4** |
| **Co-promotion** | **$0.0** | **$0.0** | **$0.0** | **$0.0** | **$0.0** | | **$0.0** | | | | | | |
| **Total Revenue** | **$899.7** | **$938.1** | **$246.0** | **$250.8** | **$252.8** | **$604.1** | **$1,353.7** | **$688.6** | **$720.9** | **$745.9** | **$747.0** | **$2,902.3** | **$3,119.1** |
| *Yr/Yr change* | *19.3%* | *4.3%* | *7.2%* | *7.1%* | *9.0%* | *149.1%* | *44.3%* | *179.9%* | *187.4%* | *195.0%* | *23.6%* | *114.4%* | *7.5%* |
| *Qtr/Qtr change* | | | *-73.8%* | *2.0%* | *0.8%* | *139.0%* | | *-49.1%* | *4.7%* | *3.5%* | *0.1%* | | |
| **OPERATING EXPENSES** | | | | | | | | | | | | | |
| Cost of goods | $182.6 | $198.8 | $48.8 | $47.0 | $44.4 | $64.1 | $204.2 | $64.0 | $69.9 | $76.8 | $81.4 | $292.2 | $355.6 |
| **Gross profit** | **$713.6** | **$739.3** | **$197.3** | **$203.8** | **$208.4** | **$540.0** | **$1,149.5** | **$624.6** | **$650.9** | **$669.1** | **$665.5** | **$2,610.1** | **$2,763.5** |
| *Yr/Yr change* | *18.4%* | *3.6%* | *8.5%* | *11.3%* | *12.6%* | *185.2%* | *55.5%* | *216.6%* | *219.3%* | *221.0%* | *23.3%* | *127.1%* | *5.9%* |
| Gross margin | *79.3%* | *78.8%* | *80.2%* | *81.3%* | *82.5%* | *89.4%* | *84.9%* | *90.7%* | *90.3%* | *89.7%* | *89.1%* | *89.9%* | *88.6%* |
| SG&A | $266.0 | $192.6 | $46.8 | $53.0 | $59.1 | $277.5 | $436.4 | $320.1 | $315.1 | $309.1 | $295.1 | $1,239.4 | $1,294.8 |
| R&D | $54.5 | $50.0 | $23.9 | $11.9 | $11.6 | $29.3 | $76.7 | $31.1 | $56.1 | $44.1 | $51.1 | $182.6 | $191.7 |
| Amortization of intangible asset | $228.3 | $223.9 | $57.0 | $57.0 | $57.0 | $141.2 | $312.2 | $160.9 | $160.9 | $160.9 | $160.9 | $643.6 | $505.1 |
| **Operating income** | **$164.8** | **$272.8** | **$69.6** | **$81.9** | **$80.7** | **$92.0** | **$324.2** | **$112.4** | **$118.8** | **$154.9** | **$158.4** | **$544.5** | **$771.9** |
| *Yr/Yr change* | *42.6%* | *65.6%* | *12.7%* | *16.3%* | *15.1%* | *30.4%* | *18.8%* | *61.5%* | *45.1%* | *91.9%* | *72.1%* | *67.9%* | *41.8%* |
| Operating margin | *18.3%* | *29.1%* | *28.3%* | *32.6%* | *31.9%* | *15.2%* | *23.9%* | *16.3%* | *16.5%* | *20.8%* | *21.2%* | *18.8%* | *24.7%* |
| Net interest | $117.6 | $93.1 | $18.0 | $15.2 | $24.0 | $67.4 | $124.6 | $72.4 | $59.6 | $59.1 | $58.5 | $249.6 | $220.4 |
| **Pretax income (loss)** | **$47.2** | **$179.7** | **$51.6** | **$66.7** | **$56.8** | **$24.6** | **$199.6** | **$40.0** | **$59.2** | **$95.8** | **$99.9** | **$294.9** | **$551.5** |
| Income taxes | $18.4 | $28.0 | $8.3 | $10.7 | $12.6 | $7.5 | $39.0 | $22.9 | $25.3 | $29.5 | $30.0 | $107.7 | $126.8 |
| **Net income (loss)** | **$28.8** | **$151.7** | **$43.3** | **$56.0** | **$44.2** | **$17.0** | **$160.5** | **$17.1** | **$33.8** | **$66.3** | **$69.9** | **$187.2** | **$424.7** |
| Net margin | *3.2%* | *16.2%* | *17.6%* | *22.3%* | *17.5%* | *2.8%* | *11.9%* | *2.5%* | *4.7%* | *8.9%* | *9.4%* | *6.4%* | *13.6%* |
| **EPS** | **$0.11** | **$0.61** | **$0.17** | **$0.22** | **$0.18** | **$0.07** | **$0.64** | **$0.07** | **$0.13** | **$0.26** | **$0.27** | **$0.74** | **$1.66** |
| Shares (Basic) | 248.6 | 249.6 | 249.6 | 249.6 | 249.6 | 249.6 | 249.6 | 249.6 | 249.6 | 249.6 | 249.6 | 249.6 | 249.6 |
| Shares (Diluted) | 250.6 | 250.7 | 250.6 | 250.7 | 251.3 | 252.5 | 251.3 | 252.9 | 255.0 | 255.0 | 255.0 | 254.5 | 256.0 |
| Amortization after tax | $208.6 | $204.5 | $52.2 | $52.2 | $52.2 | $127.4 | $284.0 | $146.8 | $145.8 | $145.8 | $145.8 | $584.1 | $457.6 |
| Deferred financing costs after tax | $12.6 | $8.0 | $2.2 | $1.0 | $6.9 | $15.5 | $25.5 | $25.0 | $17.6 | $17.6 | $17.6 | $77.9 | $64.4 |
| Other non-recurring items | $26.0 | $0.0 | $0.0 | $0.0 | $0.0 | $0.0 | $0.0 | $34.1 | $0.0 | $0.0 | $0.0 | $0.0 | $0.0 |
| **"Cash" net income** | **$275.9** | **$364.1** | **$97.7** | **$109.2** | **$103.2** | **$159.9** | **$470.1** | **$223.0** | **$197.3** | **$229.7** | **$233.3** | **$849.2** | **$946.7** |
| *Yr/Yr change* | *47.8%* | *32.0%* | *17.8%* | *29.6%* | *7.0%* | *59.2%* | *29.1%* | *128.3%* | *80.7%* | *122.5%* | *45.9%* | *80.7%* | *11.5%* |
| "Cash" net margin | *30.7%* | *38.8%* | *39.7%* | *43.5%* | *40.8%* | *26.5%* | *34.7%* | *32.4%* | *27.4%* | *30.8%* | *31.2%* | *29.3%* | *30.4%* |
| **"Cash" EPS** | **$1.10** | **$1.45** | **$0.39** | **$0.44** | **$0.41** | **$0.63** | **$1.87** | **$0.88** | **$0.77** | **$0.90** | **$0.91** | **$3.34** | **$3.70** |

Note: Cash EPS = Adjusted EPS + amortization + differed financing cost
Source: Company reports and Wells Fargo Securities, LLC estimates

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 5/2/2007 | | Tong | | | |
| | 5/2/2007 | NA | 1 | 17.00 | 19.00 | 16.84 |
| ● | 5/11/2007 | 16.25 | 1 | 19.00 | 21.00 | 16.19 |
| ● | 6/17/2007 | 17.67 | 1 | 20.00 | 22.00 | 17.64 |
| ● | 5/9/2008 | 16.75 | 1 | 21.00 | 22.00 | 16.80 |
| ● | 8/8/2008 | 16.24 | 1 | 21.00 | 23.00 | 16.37 |
| ● | 11/10/2008 | 13.74 | 1 | 19.00 | 22.00 | 13.71 |
| ● | 3/17/2009 | 9.75 | 1 | 14.00 | 16.00 | 9.99 |
| ● | 8/7/2009 | 16.20 | 1 | 18.00 | 20.00 | 16.23 |
| ● | 8/24/2009 | 20.41 | 1 | 24.00 | 26.00 | 20.41 |
| ● | 9/23/2009 | 19.97 | 1 | 24.00 | 25.00 | 19.87 |
| ● | 11/10/2009 | 22.18 | 1 | 26.00 | 29.00 | 22.61 |
| ● | 12/16/2009 | 27.89 | 1 | 29.00 | 32.00 | 27.89 |
| ● | 1/29/2010 | 27.67 | 1 | 30.00 | 33.00 | 27.33 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- □ Split Adjustment

**Rating Code Key**
- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

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**WCRX:** Risks to the stock trading to our valuation range include the inability to integrate PGP effectively and deceleration in core product growth.

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## SECTOR RATING

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As of: May 7, 2010

| | |
|---|---|
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SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE

May 7, 2010

WELLS FARGO SECURITIES

# *Equity Research*

## Westar Energy, Inc.

**WR: Bests Q1 Expectations On Strong Sales Growth**
**Reiterate Outperform Rating**

**Outperform**

Sector: Regulated Electric Utilities
Market Weight

***Earnings Reported***

| EPS | 2009A | 2010E Curr. | 2010E Prior | 2011E Curr. | 2011E Prior |
|---|---|---|---|---|---|
| **Q1** (Mar.) | $0.10 | **$0.27 A** | **0.24** | NE | |
| **Q2** (June) | 0.35 | **0.39** | **0.38** | NE | |
| **Q3** (Sep.) | 0.73 | **0.92** | **0.93** | NE | |
| **Q4** (Dec.) | 0.14 | **0.18** | **0.20** | NE | |
| **FY** | $1.33 | $1.75 | NC | $1.70 | NC |
| **CY** | $1.33 | $1.75 | | $1.70 | |
| **FY P/E** | 16.7x | 12.7x | | 13.0x | |
| **Rev.(MM)** | $1,858 | $2,024 | | $2,099 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

- **Summary.** WR reported Q1 results of $0.27, above our estimate of $0.24 and consensus of $0.18. Strong results were driven by a 6.8% increase in retail sales (favorable weather and strong underlying growth). Management reiterated 2010 EPS guidance of $1.65-1.80 and we are maintaining our 10-12E EPS of $1.75, $1.70 and $2.15. We reiterate our Outperform rating and $24-25 valuation range.
- **Sales Impress.** While weather was a benefit (heating degree days 10% above normal), it appears that strong underlying sales growth, including a 6.2% rise in economically sensitive industrial sales, drove roughly 4% of the 6.8% retail sales growth. This compares with WR's full-year assumption of 2% weather-adjusted retail sales growth. Kansas' economy continues to outperform the national economy (6.5% unemployment) and management noted strength in the oil and gas and food/pet food industries; aircraft manufacturers continue to lag.
- **EPS Outlook.** WR reiterated 2010 EPS guidance of $1.65-1.80. We are maintaining our 2010E EPS of $1.75 despite a better-than-expected Q1. Should weather-adjusted sales growth continue to trend above plan we believe there is upside to our estimate. That said, our estimate assumes $11MM of COLI proceeds, none of which have been realized in Q1. We are also maintaining our 2011E and 2012E of $1.70 and $2.15. See Figure 1 for the key assumptions underlying our 2010-13 EPS estimates.
- **Rate Case/Equity Comments.** Management noted that favorable sales and cost trends could allow WR to defer a general rate case filing. We continue to assume an early 2011 filing with new rates effective early 2012. Rate case timing likely also impacts the timing of equity needs as we believe the company has 3-4 months after filing a rate case to have that equity incorporated in the case, aimed to achieve at least a 50% equity ratio. We believe WR will likely use a mixture of its three-year $500MM dribble program and a secondary offering to meet equity needs. Our model assumes $375MM of equity issued in mid-2011.
- **Reiterate Outperform.** Favorable attributes, in our view, include a sound regulatory environment, including rider mechanisms for transmission and environmental investment, a strong management team, and attractive valuation (7% discount to peers on 2012 EPS). Shares offer a 5.6% yield on the common dividend, which we consider to be secure with modest growth potential.

| | |
|---|---|
| Ticker | WR |
| Price (05/07/2010) | $22.16 |
| 52-Week Range: | $16-24 |
| Shares Outstanding: (MM) | 110.4 |
| Market Cap.: (MM) | $2,446.5 |
| S&P 500: | 1,106.61 |
| Avg. Daily Vol.: | 1,018,050 |
| Dividend/Yield: | $1.24/5.6% |
| LT Debt: (MM) | $2,490.5 |
| LT Debt/Total Cap.: | 49.9% |
| ROE: | 9.0% |
| 3-5 Yr. Est. Growth Rate: | 5.0% |
| CY 2010 Est. P/E-to-Growth: | 2.5x |
| Last Reporting Date: | 05/06/2010 After Close |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

**Valuation Range: $24.00 to $25.00**
Our valuation range is based on a P/E multiple (apply an 11-11.5X multiple to our 12E EPS of $2.15), residual income and dividend discount analyses. Risks to our valuation include adverse regulatory developments and the impact of a continued economic downturn.

**Investment Thesis:**
We rate shares Outperform. We are attracted to Westar's significant rate base growth opportunities, primarily related to transmission and environmental investment, supportive regulatory and political environment and flexible strategy. In addition, shares offer a 5.6% yield on the common dividend.

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**Please see page 5 for rating definitions, important disclosures and required analyst certifications**

## Company Description:

Westar Energy is a regulated electric utility that provides generation, transmission, and distribution services to 674,000 customers in Kansas, including the cities of Topeka, Lawrence, Manhattan, Salina, and Hutchinson. Westar Energy North provides service in central and northeastern Kansas and Kansas Gas & Electric, a wholly owned subsidiary, provides service in the central south and southeast portions of the state. Other businesses include wholesale power sales and energy marketing.

**Figure 1: EPS Breakdown, 2010-13E**

| ($ mil. except per share numbers) | 2010E | 2011E | 2012E | 2013E |
|---|---|---|---|---|
| **Regulated Operations** | | | | |
| Avg. Rate Base - Base/CWIP/Environmental | $3,821 | $4,071 | $4,501 | $4,867 |
| Equity Ratio | 50% | 50% | 50% | 50% |
| ROE | 7.5% | 7.1% | 9.3% | 8.9% |
| Earnings | $142 | $145 | $210 | $215 |
| Avg. Rate Base - Transmission | $696 | $847 | $989 | $1,164 |
| Equity Ratio | 48% | 48% | 48% | 48% |
| ROE | 11.5% | 11.5% | 11.5% | 11.5% |
| Earnings | $38 | $47 | $55 | $64 |
| **Total Regulated Earnings** | **$181** | **$192** | **$265** | **$280** |
| Avg. Diluted Shares Outstanding | 111 | 121 | 130 | 136 |
| **Regulated EPS** | **$1.62** | **$1.59** | **$2.04** | **$2.05** |
| **COLI** | | | | |
| Proceeds/Earnings | $11 | $11 | $11 | $11 |
| **COLI EPS** | **$0.10** | **$0.09** | **$0.08** | **$0.08** |
| **Energy Marketing** | | | | |
| Gross Margin | $8.0 | $8.0 | $8.0 | $8.0 |
| SG&A | 3.5 | 3.5 | 3.5 | 4.5 |
| Earnings (assuming a 40% tax rate) | 2.7 | 2.7 | 2.7 | 2.1 |
| **Energy Marketing EPS** | **$0.02** | **$0.02** | **$0.02** | **$0.02** |
| **TOTAL EPS** | **$1.75** | **$1.70** | **$2.15** | **$2.15** |
| *Guidance* | *$1.65-1.80* | | | |

Source: Wells Fargo Securities, LLC Estimates

| Earnings Model (in millions except per share data) | 2006 | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E | 2013E | 2014E |
|---|---|---|---|---|---|---|---|---|---|
| **Revenues** | **$1,606** | **$1,727** | **$1,839** | **$1,858** | **$2,024** | **$2,099** | **$2,290** | **$2,398** | **$2,509** |
| **Expenses** | | | | | | | | | |
| Fuel and purchased power | $484 | $544 | $694 | $535 | $554 | $560 | $565 | $571 | $577 |
| Operating and maintenance | 464 | 474 | 472 | 517 | 541 | 558 | 574 | 592 | 609 |
| Depreciation and amortization | 180 | 193 | 204 | 252 | 269 | 290 | 326 | 367 | 403 |
| Selling, general and administrative | 171 | 179 | 184 | 200 | 201 | 207 | 213 | 219 | 226 |
| **Total Operating Expenses** | **$1,299** | **$1,389** | **$1,554** | **$1,503** | **$1,566** | **$1,614** | **$1,679** | **$1,749** | **$1,815** |
| **Operating Income** | **$307** | **$337** | **$285** | **$355** | **$458** | **$485** | **$611** | **$649** | **$693** |
| Total Other Income | $14 | ($1) | $4 | $3 | ($9) | ($9) | ($9) | ($6) | $1 |
| Total Interest Expense | 99 | 104 | 106 | 157 | 170 | 180 | 202 | 224 | 240 |
| Income Taxes | 56 | 64 | 4 | 59 | 84 | 89 | 120 | 125 | 134 |
| *Tax Rate* | *25%* | *27%* | *2%* | *29%* | *30%* | *30%* | *30%* | *30%* | *29%* |
| **Income From Continuing Operations** | **165** | **168** | **178** | **141** | **196** | **207** | **280** | **294** | **321** |
| Discontinued operations, net of tax | 0 | 0 | 0 | 34 | 0 | 0 | 0 | 0 | 0 |
| **Net Income** | **$165** | **$168** | **$178** | **$175** | **$196** | **$207** | **$280** | **$294** | **$321** |
| Preferred dividends | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| **Earnings for Common** | **$164** | **$167** | **$177** | **$174** | **$195** | **$206** | **$279** | **$293** | **$321** |
| **Average Shares - Diluted** | **88** | **91** | **104** | **110** | **111** | **121** | **130** | **136** | **143** |
| **EPS** | **$1.87** | **$1.83** | **$1.70** | **$1.59** | **$1.75** | **$1.70** | **$2.15** | **$2.15** | **$2.25** |
| Discontinued Operations, net of tax | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Other Non-Recurring Items | 0.00 | 0.00 | 0.38 | 0.26 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| **EPS (Diluted)** | **$1.87** | **$1.83** | **$1.32** | **$1.33** | **$1.75** | **$1.70** | **$2.15** | **$2.15** | **$2.25** |
| **Dividend Information** | | | | | | | | | |
| Dividends Paid Per Year | $1.00 | $1.08 | $1.16 | $1.20 | $1.24 | $1.28 | $1.32 | $1.35 | $1.40 |
| Payout Ratio | 54% | 59% | 88% | 90% | 71% | 75% | 61% | 63% | 62% |
| **Statistics** | | | | | | | | | |
| Book Value - Year End | $17.61 | $18.69 | $20.18 | $20.59 | $21.15 | $21.83 | $22.70 | $23.77 | $24.66 |
| Avg Book Value | $16.96 | $18.15 | $19.44 | $20.38 | $20.87 | $21.49 | $22.26 | $23.23 | $24.21 |
| **ROE (%)** | **11.0** | **10.1** | **6.8** | **6.5** | **8.4** | **7.9** | **9.7** | **9.3** | **9.3** |
| EBITDA Per Share | $5.57 | $5.85 | $4.70 | $5.53 | $6.56 | $6.42 | $7.25 | $7.48 | $7.71 |
| Free CFPS | $2.00 | $1.74 | $1.59 | $3.25 | $2.79 | $3.01 | $3.53 | $3.49 | $3.58 |
| Free Cash Flow | ($170) | ($591) | ($754) | ($200) | ($355) | ($438) | ($467) | ($474) | ($391) |

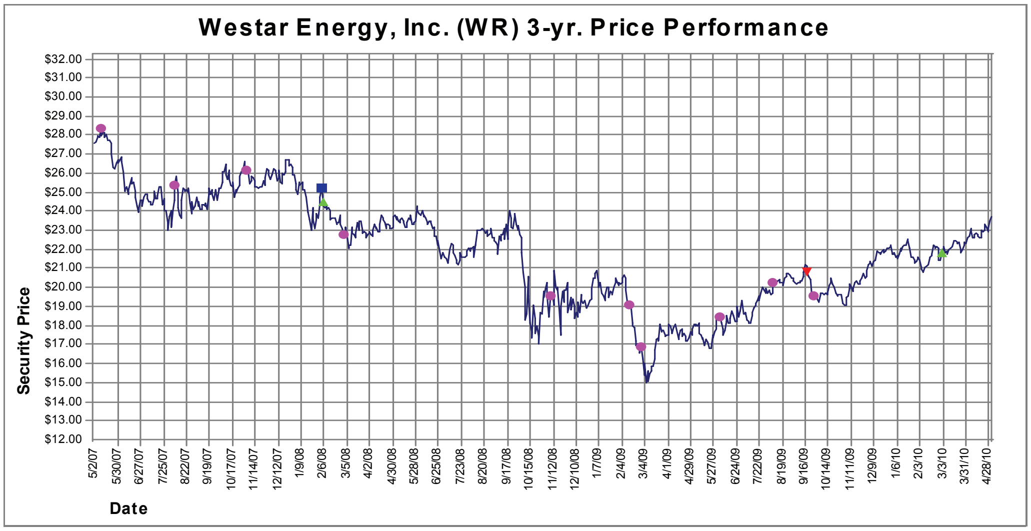
Sources: Wells Fargo Securities, LLC estimates and company filings

| Cash Flow Model (in millions) | 2006 | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E | 2013E | 2014E |
|---|---|---|---|---|---|---|---|---|---|
| **Operating Cash Flow** | | | | | | | | | |
| Net Income | $165 | $168 | $178 | $175 | $196 | $207 | $280 | $294 | $321 |
| Discontinued Operations, net | 0 | 0 | 0 | (34) | 0 | 0 | 0 | 0 | 0 |
| Depreciation & Amortization | 204 | 218 | 232 | 284 | 269 | 290 | 326 | 367 | 403 |
| Other - net | (113) | (139) | (135) | 53 | (18) | 20 | 20 | (2) | (17) |
| **Net Operating Cash Flow** | **$256** | **$247** | **$275** | **$479** | **$447** | **$517** | **$626** | **$658** | **$708** |
| **Investing Cash Flow** | | | | | | | | | |
| Additions to property, plant and equipment | | | | | | | | | |
| Generation: | | | | | | | | | |
| Replacement and other | ($51) | ($45) | ($121) | ($104) | ($100) | ($106) | ($127) | ($130) | ($133) |
| Additional capacity | (75) | (190) | (129) | (17) | (12) | (10) | 0 | 0 | 0 |
| Wind | 0 | (79) | (130) | (69) | 0 | 0 | 0 | (95) | (190) |
| Environmental | (47) | (208) | (257) | (85) | (181) | (350) | (415) | (300) | (250) |
| Nuclear fuel | (26) | (38) | (18) | (20) | (36) | (27) | (26) | (27) | (27) |
| Transmission | (32) | (71) | (150) | (157) | (203) | (168) | (200) | (250) | (150) |
| Distribution: | | | | | | | | | |
| Replacements, new customers and other | (38) | (35) | (46) | (93) | (102) | (115) | (119) | (122) | (125) |
| Smart Grid | | | | | (9) | (9) | (12) | 0 | 0 |
| New Customers | (64) | (61) | (54) | 0 | 0 | 0 | 0 | 0 | 0 |
| Other | (12) | (22) | (14) | (12) | (20) | (16) | (25) | (25) | (25) |
| **Total CapEx** | **($345)** | **($748)** | **($919)** | **($556)** | **($664)** | **($801)** | **($924)** | **($948)** | **($900)** |
| Other | 55 | (14) | 13 | (17) | 0 | 0 | 0 | 2 | 17 |
| **Net Investing Cash Flow** | **($290)** | **($762)** | **($906)** | **($572)** | **($664)** | **($801)** | **($924)** | **($946)** | **($884)** |
| **Financing Cash Flow** | | | | | | | | | |
| Issuance of common stock, net | $2 | $195 | $294 | $5 | $80 | $375 | $25 | $315 | $25 |
| Proceeds from long-term debt | 100 | 322 | 545 | 348 | 100 | 100 | 650 | 0 | 600 |
| Retirements of long-term debt | (200) | (0) | (101) | (197) | (1) | (1) | 0 | 0 | (250) |
| Short-term debt, net | 160 | 20 | (5) | 68 | 175 | (25) | (200) | 150 | 0 |
| Borrowings/Repayments against COLI CV | 36 | 59 | 36 | 7 | 0 | 0 | 0 | 0 | 0 |
| Cash dividends paid | (81) | (89) | (110) | (123) | (138) | (154) | (170) | (184) | (199) |
| Other | (4) | (5) | (9) | (10) | 0 | 0 | 0 | 0 | 0 |
| **Net Investing Cash Flow** | **$13** | **$503** | **$649** | **$97** | **$216** | **$295** | **$305** | **$281** | **$176** |
| **Net cash from discontinued operations** | **$1** | **$0** | **$0** | **($23)** | **$0** | **$0** | **$0** | **$0** | **$0** |
| Net Change in Cash | ($20) | ($12) | $17 | ($19) | ($1) | $12 | $8 | ($7) | $0 |
| Cash at Beginning of Period | $39 | $18 | $6 | $23 | $4 | $3 | $15 | $22 | $15 |
| **Cash at End of Period** | **$18** | **$6** | **$23** | **$4** | **$3** | **$15** | **$22** | **$15** | **$16** |

| Capital Structure (in millions) | 2006 | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E | 2013E | 2014E |
|---|---|---|---|---|---|---|---|---|---|
| Common Equity | $1,539 | $1,827 | $2,186 | $2,245 | $2,383 | $2,811 | $2,946 | $3,371 | $3,519 |
| Long-Term Debt | 1,563 | 1,890 | 2,193 | 2,491 | 2,589 | 2,689 | 3,339 | 3,339 | 3,689 |
| Short-Term Debt | 160 | 181 | 321 | 244 | 419 | 394 | 194 | 344 | 344 |
| Preferred | 21 | 21 | 21 | 21 | 21 | 21 | 21 | 21 | 21 |
| **Total Capitalization** | **$3,284** | **$3,919** | **$4,721** | **$5,002** | **$5,413** | **$5,915** | **$6,500** | **$7,075** | **$7,573** |
| % Common Equity | 47% | 47% | 46% | 45% | 44% | 48% | 45% | 48% | 46% |
| % LT Debt | 48% | 48% | 46% | 50% | 48% | 45% | 51% | 47% | 49% |
| % ST Debt | 5% | 5% | 7% | 5% | 8% | 7% | 3% | 5% | 5% |
| % Preferred | 1% | 1% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |

Sources: Wells Fargo Securities, LLC estimates and company filings

# Required Disclosures




| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| | 5/2/2007 | | Brothwell | | | |
| | 5/2/2007 | NA | 2 | 25.00 | 27.00 | 27.60 |
| ● | 5/9/2007 | NA | 2 | 27.00 | 29.00 | 28.31 |
| ● | 8/8/2007 | NA | 2 | 24.00 | 27.00 | 25.40 |
| ● | 11/2/2007 | 26.04 | 2 | 25.00 | 28.00 | 26.17 |
| ■ | 2/4/2008 | | Kalton | | | |
| ▲ ● | 2/5/2008 | 25.18 | 1 | 28.00 | 29.00 | 24.49 |
| ● | 2/29/2008 | 22.76 | 1 | 26.00 | 28.00 | 22.73 |
| ● | 11/7/2008 | 19.68 | 1 | 22.00 | 24.00 | 19.53 |
| ● | 2/12/2009 | 18.81 | 1 | 21.00 | 23.00 | 19.11 |
| ● | 2/27/2009 | 17.21 | 1 | 19.00 | 20.00 | 16.90 |
| ● | 6/3/2009 | 18.41 | 1 | 20.00 | 21.00 | 18.42 |
| ● | 8/7/2009 | 20.14 | 1 | 21.00 | 22.00 | 20.29 |
| ▼ ● | 9/18/2009 | 21.09 | 2 | 22.00 | 23.00 | 20.80 |
| ● | 9/25/2009 | 19.48 | 2 | 21.00 | 22.00 | 19.51 |
| ▲ ● | 3/2/2010 | 21.44 | 1 | 24.00 | 25.00 | 21.86 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- □ Split Adjustment

**Rating Code Key**
- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

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**SECTOR RATING**
**O=Overweight:** Industry expected to outperform the relevant broad market benchmark over the next 12 months.
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As of: May 7, 2010

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May 7, 2010

*Equity Research*

# Western Gas Partners, L.P.

**WES: Q1 2010 Results Slightly Above Forecast--Raising Estimates**

**Market Perform / V**

Sector: Gathering & Processing MLPs
Overweight

- **Key Takeaways.** Q1 results exceeded our forecast on higher product margin. WES increased its distribution 3% sequentially, which was essentially in line with our forecast. We are increasing our 2010 DCF per unit estimate to $1.85 from $1.82 to reflect Q1 results. Management reiterated its 2010 EBITDA guidance of $130-150MM, which is in line with our current and prior forecast. Although management indicated that it is focused on potential dropdowns from Anadarko (the GP sponsor), WES also continues to evaluate third-party acquisition opportunities. We maintain our Market Perform rating, as WES's growth prospects appear fairly reflected in the current valuation, in our view.
- **Q1 Results Slightly Ahead Of Forecast.** Q1 adjusted EBITDA was $36.5MM versus our estimate of $33.9MM. The variance from our estimate is primarily due to stronger-than-anticipated contributions from the sale of condensate. The benefit more than offset lower total throughput attributable to WES of 1.375 Bcf/d versus our estimate of 1.401 Bcf/d. Q1 EPU was $0.37 versus our estimate of $0.35, consensus of $0.33, and $0.30 a year ago.
- **Quarterly DCF Beats--Distribution Essentially In Line.** Q1 DCF per unit of $0.52 exceeded our estimate of $0.45 and provided distribution coverage of 1.5x (excess cash flow of about $11MM). The positive variance was attributable to Q1 earnings and the timing of maintenance capex. WES increased its quarterly distribution 3% sequentially to $0.34 per unit ($1.36 per unit), which was essentially in line with our estimate of $0.3375 per unit). Based on the Q1 declared distribution, we are increasing our 2010 distribution growth estimate to 10.9% from 10.1%.

### *Earnings Estimates Revised Up*

| | 2009A | 2010E | | 2011E | |
|---|---|---|---|---|---|
| **DCF/unit** | | **Curr.** | **Prior** | **Curr.** | **Prior** |
| **Q1** (Mar.) | $0.38 | **$0.52 A** | **0.45** | $0.43 | NC |
| **Q2** (June) | 0.40 | **0.43** | **0.44** | **0.46** | **0.47** |
| **Q3** (Sep.) | 0.43 | **0.45** | **0.46** | 0.46 | NC |
| **Q4** (Dec.) | 0.45 | **0.45** | **0.47** | 0.47 | NC |
| **FY** | $1.66 | **$1.85** | **1.82** | $1.84 | NC |
| **CY** | $1.66 | $1.85 | | $1.84 | |
| **FY P/DCF** | 13.3x | 11.9x | | 12.0x | |
| **Rev.(MM)** | $224 | $305 | | $327 | |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*
*NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*

### Valuation Range: $21.00 to $23.00

Our valuation range is based on a blend of (1) our three-stage distribution discount model, which assumes a required rate of return of 9.0% and a long-term growth rate of 1.25%, and (2) a price-to-distributable cash flow multiple of about 11.5x our 2010 estimate. Risks to the units trading below our valuation range include a slower than forecast rate of dropdowns, customer concentration, and rising interest rates.

### Investment Thesis:

WES is a high-quality midstream MLP with predominantly fee-based cash flow and visible growth prospects. However, these attributes appear to be fairly reflected in the valuation. The partnership has a built-in growth platform with more than $3 billion of midstream assets that it could potentially acquire from its GP sponsor over time and organic opportunities tied to Anadarko's drilling activity in its areas of operation. Approximately 70% of WES' distribution is tax deferred.

| | |
|---|---|
| Ticker | WES |
| Price (05/06/2010) | $22.05 |
| 52-Week Range: | $13-24 |
| Shares Outstanding: (MM) | 63.5 |
| Market Cap.: (MM) | $1,400.2 |
| S&P 500: | 1,128.15 |
| Avg. Daily Vol.: | 122,174 |
| Dividend/Yield: | $1.36/6.2% |
| LT Debt: (MM) | $175.0 |
| LT Debt/Total Cap.: | 17.0% |
| ROE: | NM |
| 3-5 Yr. Est. Growth Rate: | 9.0% |
| CY 2010 Est. P/DCF/unit-to-Growth: | 1.3x |
| Last Reporting Date: | 05/05/2010 After Close |

*Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters*

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**Please see page 7 for rating definitions, important disclosures and required analyst certifications**

## Company Description:

Western Gas Partners, L.P. (WES) is a Texas based master limited partnership (MLP) involved in the gathering, compressing, processing, treating, and transportation of natural gas. The partnership's operations are located in East Texas, the Rocky Mountains, the Mid-Continent, and West Texas. WES' general partner and sponsor is Anadarko Petroleum Corporation (APC), one of the largest independent oil and gas exploration and production companies in the world. APC also owns a significant portfolio of midstream assets located in active oil and natural gas producing regions of the United States.

### Q1 Results Slightly Ahead Of Forecast

Q1 adjusted EBITDA was $36.5MM versus our estimate of $33.9MM. The variance from our estimate is primarily due to stronger-than-anticipated contributions from the sale of condensate. The benefit more than offset lower total throughput attributable to WES of 1.375 Bcf/d versus our estimate of 1.401 Bcf/d. Q1 EPU was $0.37 versus our estimate of $0.35, consensus of $0.33, and $0.30 a year ago.

For 2010, management expects drilling to remain fairly active behind WES's operating footprint. The partnership anticipates the most drilling activity to occur around its Chipeta and Granger assets in the Natural Buttes and Pinedale regions, as the high liquids content improves the producers' economics. Management expects growth on these two assets to be supplemented by drilling around its Hugoton and Haley systems.

### WES Q1 Variance

| *($MM, except per unit data)* | **Q1'09A** | **Q4'09A** | **Q1'10E** | **Q1'10A** | **Var ($)** | **Var (%)** |
|---|---|---|---|---|---|---|
| **Adjusted EBITDA** | **$23.1** | **$29.6** | **$33.9** | **$36.5** | **$2.6** | **8%** |
| (-) Interest expense | $1.8 | $3.3 | $3.3 | **$3.5** | $0.3 | 8% |
| (-) Maintenance capex | $4.2 | $4.0 | $5.8 | **$3.9** | ($1.9) | (32%) |
| (-) Other | $0.0 | $0.0 | $0.0 | **$0.0** | $0.0 | NM |
| (+) Interest income | $4.2 | $4.2 | $4.2 | **$4.2** | $0.0 | 0% |
| **Available Cash Flow** | **$21.3** | **$26.6** | **$29.1** | **$33.3** | **$4.2** | **15%** |
| GP Interest | $0.3 | $0.4 | $0.4 | **$0.4** | $0.0 | 1% |
| **Distributable Cash Flow** | **$20.9** | **$26.1** | **$28.6** | **$32.8** | **$4.2** | **15%** |
| **DCF/unit** | **$0.38** | **$0.45** | **$0.45** | **$0.52** | **$0.07** | **15%** |
| Distribution/unit | $0.30 | $0.33 | $0.34 | **$0.34** | $0.00 | 1% |
| Distribution coverage ratio | 1.2x | 1.3x | 1.3x | **1.5x** | NM | NM |
| Excess cash flow | $4.2 | $5.4 | $7.2 | **$11.2** | $4.1 | NM |
| EPU | $0.30 | $0.33 | $0.35 | **$0.37** | $0.02 | 7% |

Source: Partnership reports and Wells Fargo Securities, LLC estimates

### Balance Sheet/Liquidity Position Remains Solid

WES currently has available liquidity of approximately $295MM, which includes $140MM from its credit facility, $100MM under APC's credit facility, and $55MM of cash. The partnership also has access to a $30MM working capital facility. WES's liquidity position appears more than sufficient to fund our 2010 organic growth forecast of $20MM and assumed $100MM acquisition in Q4 2010.

At the end of Q1, the partnership's debt-to-EBITDA and EBITDA-to-interest expense ratios were 2.6x and 10.3x, respectively, based on annualized quarterly results. This compares to the gathering & processing MLP peer group medians of 3.7x and 4.2x, respectively.

**WES 2010E Financing Overview**

| **Breakdown Of 2010 Capex** *($ in millions)* | |
|---|---|
| Organic growth | $20 |
| Acquisition - assumed | $100 |
| Acquisition - completed | $254 |
| **Total capex** | **$374** |
| | |
| **Total Debt Maturities** | **$0** |
| | |
| **Total Estimated Capital Requirements** | **$374** |

| **Breakdown Of 2010 Funding** *($ in millions)* | |
|---|---|
| Revolving credit facility / (Repayment) | $232 |
| Senior notes issuance - assumed | $50 |
| **Total Available Debt Funding** | **$282** |
| | |
| Secondary issuances - completed | $13 |
| Secondary issuances - assumed | $50 |
| **Total Available Equity Funding** | **$63** |
| | |
| **Other** (i.e. excess cash flow estimate) | $30 |
| | |
| **Total Estimated Available Funding** | **$374** |
| **2010E Pro Forma Debt / EBITDA** | **2.8x** |
| **Unadjusted 2010E debt-to-EBITDA** | **3.0x** |

| **Pro forma 2010E debt** | **$433** |
|---|---|
| 2010E adjusted EBITDA | $146 |
| (+) full year contribution from Q4'10 dropdown | $8 |
| (+) organic growth projects | $1 |
| **Pro forma 2010E EBITDA** | **$155** |

Source: Wells Fargo Securities, LLC estimates

## Quarterly DCF Beats--Distribution Essentially In Line

Q1 DCF per unit of $0.52 exceeded our estimate of $0.45 and provided distribution coverage of 1.5x (excess cash flow of about $11MM). The positive variance was attributable to Q1 earnings and the timing of maintenance capex. WES increased its quarterly distribution 3% sequentially to $0.34 per unit (annual rate of $1.36 per unit), which was essentially in line with our estimate of $0.3375 per unit. Based on the Q1 declared distribution, we are increasing our 2010 distribution growth estimate to 10.9% from 10.1%.

## Management Reiterates 2010 EBITDA Guidance Of $130-150MM

Management maintained its 2010 EBITDA guidance for the partnership of $130-150MM. This is in line with our current forecast of $143MM (which excludes approximately $3MM of incremental cash flow from our assumed Q4 2010 $100MM acquisition) and prior estimate of approximately $140MM. The difference between our current and prior forecast is related to Q1 earnings. WES also continues to expect to spend $28-32MM on total capex, with maintenance capex accounting for about $22-25MM (based on the midpoint of management's maintenance capex guidance of 15-18% of EBITDA).

**WES 2010 Guidance Versus Our Revised And Prior Forecast**

| *($MM, except per unit data)* | WES Guidance Low | WES Guidance High | 2010E (No Acqs) | + $100MM Acq Q4'10 | = New 2010E | Old 2010E | Δ From Prev |
|---|---|---|---|---|---|---|---|
| Adjusted EBITDA | $130.0 | $150.0 | **$142.8** | $2.8 | **$145.6** | $142.9 | 2% |
| (-) Interest expense | $16.7 | $16.7 | **$17.2** | $0.9 | **$18.2** | $17.7 | 3% |
| (-) Maintenance capex | $21.5 | $24.8 | **$23.0** | $0.5 | **$23.5** | $23.5 | 0% |
| (-) Other | $0.0 | $0.0 | **$0.0** | $0.0 | **$0.0** | $0.0 | NM |
| (+) Interest income | $16.9 | $16.9 | **$16.9** | $0.0 | **$16.9** | $16.9 | 0% |
| Available Cash Flow | $108.8 | $125.5 | **$119.5** | $1.3 | **$120.8** | $118.6 | 2% |
| GP Interest | $1.7 | $1.7 | **$2.0** | $0.0 | **$2.0** | $1.9 | 4% |
| Distributable Cash Flow | $107.0 | $123.7 | **$117.5** | $1.3 | **$118.8** | $116.7 | 2% |
| DCF/unit | $1.68 | $1.95 | **$1.85** | $0.01 | **$1.85** | $1.82 | 2% |
| Distribution/unit | $1.32 | $1.32 | **$1.40** | | **$1.40** | $1.39 | 1% |
| Implied coverage ratio | 1.3x | 1.5x | **1.3x** | | **1.3x** | 1.3x | 1% |
| Growth capex | $6.6 | $7.3 | **$20.0** | $0.0 | **$20.0** | $20.0 | 0% |
| Mcapex as % of EBITDA | 17% | 17% | **16%** | 0% | **16%** | 16% | (2%) |

Source: Partnership reports and Wells Fargo Securities, LLC estimates

## Adjusting 2010 Estimates--No Change To 2011

We are raising our 2010 DCF per unit and EPU estimates to $1.85 and $1.43, respectively, from $1.82 and $1.41 to reflect the Q1 variance. There is no change to our 2011 DCF per unit and EPU forecast of $1.84 and $1.36, respectively.

**Estimate Change Summary**

| *($MM, except per unit data)* | Revised 2010E | Previous 2010E | Variance | 2011E |
|---|---|---|---|---|
| Net Income | **$92.2** | $92.0 | 0.2% | **$98.2** |
| Recurring EPU | **$1.43** | $1.41 | 1.4% | **$1.36** |
| Average units outstanding | **64.1** | 64.1 | (0.0%) | **69.1** |
| Depreciation and amortization | **54.0** | 53.3 | 1.3% | **64.5** |
| Adjusted EBITDA | **$145.6** | $142.9 | 1.9% | **$177.7** |
| Interest expense | **$18.2** | $17.7 | 2.7% | **$35.2** |
| Maintenance capex | **$23.5** | $23.5 | 0.0% | **$28.5** |
| Distributable Cash Flow | **$118.8** | $116.7 | 1.8% | **$126.7** |
| DCF/unit | **$1.85** | $1.82 | 1.8% | **$1.84** |
| Distribution per unit | **$1.40** | $1.39 | 0.7% | **$1.53** |
| Coverage ratio | **1.33x** | 1.32x | 1.1% | **1.19x** |
| Excess cash flow | **$30.0** | $28.5 | 5.3% | **$21.0** |

Source: Wells Fargo Securities, LLC estimates

**WES Valuation--$21-23 Per Unit**

Our valuation range of $21-23 per unit is predicated on a combination of a dividend discount model and price-to-DCF multiple. Our DDM yields a valuation of $23 per unit, and assumes a long-term distribution growth rate of 1.25%, and a required rate of return of 9.0%. The low-end of our valuation range reflects a price-to-DCF multiple of about 11.5x our 2010 DCF per unit estimate of $1.85. Risks to the units trading below our valuation range include a slower-than-forecast rate of dropdown acquisitions, customer concentration, and rising interest rates.

WES currently yields 6.2% and trades at 2010E and 2011E price-to-distributable cash flow multiples of 11.9x and 12.0x, respectively. This compares to the gathering and processing MLP peer group medians of 8.4%, 9.2x, and 7.8x, respectively. The partnership's 2010 and five-year distribution growth rate estimates are 10.9% and 9.0%, respectively, as compared to the gathering and processing MLP peer group medians of 0.6% and 4.6%.

**WES Versus Peer Group**

| | | Price | | Price/DCF | | Distr. Growth Ests. | | |
|---|---|---|---|---|---|---|---|---|
| **MLP** | **Ticker** | **5/6/10** | **Yield** | **2010E** | **2011E** | **1-year** | **3-year** | **5-year** |
| Western Gas Partners, L.P. | WES | $22.05 | 6.2% | 11.9x | 12.0x | 10.9% | 10.0% | 9.0% |
| Gathering & Processing MLP Median | | | 8.4% | 9.2x | 7.8x | 0.6% | 4.9% | 4.6% |

Source: FactSet and Wells Fargo Securities, LLC estimates

## WESTERN GAS PARTNERS, L.P. - OPERATIONAL SUMMARY

| *Year ended December 31*<br>*($ in millions, except for per unit data)* | **FY2009A** | *Q1'10A* | *Q2'10E* | *Q3'10E* | *Q4'10E* | **FY2010E** | **FY2011E** | **FY2012E** | **FY2013E** | **FY2014E** |
|---|---|---|---|---|---|---|---|---|---|---|
| Total throughput (MMcf per day) | **1,218** | 1,445 | 1,477 | 1,492 | 1,507 | **1,480** | **1,532** | **1,573** | **1,611** | **1,647** |
| **Total adjusted EBITDA** | **104** | 36.5 | 34.6 | 35.6 | 38.9 | **145.6** | **177.7** | **224.7** | **271.3** | **317.6** |
| EPU | **$1.24** | $0.37 | $0.34 | $0.35 | $0.35 | **$1.43** | **$1.36** | **$1.44** | **$1.49** | **$1.49** |
| Average units outstanding | **56.2** | 63.5 | 63.5 | 63.5 | 65.6 | **64.1** | **69.1** | **75.5** | **81.5** | **87.0** |
| **Distributable cash flow (DCF)** | | | | | | | | | | |
| Net income | **71** | 23 | 22 | 23 | 24 | **92** | **98** | **116** | **135** | **154** |
| (+) Depreciation and amortization | **37** | 13 | 13 | 13 | 14 | **53** | **64** | **79** | **94** | **109** |
| (-) Maintenance capital expenditure | **16** | 4 | 6 | 6 | 7 | **24** | **29** | **36** | **43** | **50** |
| (-) Other | **(4)** | (2) | (0) | (0) | (0) | **(2)** | **(1)** | **(1)** | **(1)** | **(1)** |
| (-) Earnings from unconsolidated affiliates | **7** | 1 | 2 | 2 | 2 | **7** | **8** | **8** | **8** | **8** |
| (+) Cash distribution from unconsolidated affiliates | **5** | 1 | 2 | 2 | 2 | **6** | **7** | **7** | **7** | **7** |
| (-) DD&A expense tied to minority interest in Chipeta | **0** | 0 | 1 | 1 | 1 | **2** | **3** | **3** | **3** | **3** |
| **Available cash flow** | **95** | 33 | 28 | 29 | 30 | **121** | **131** | **157** | **184** | **211** |
| General partner's interest | **(1)** | (0) | (0) | (1) | (1) | **(2)** | **(4)** | **(8)** | **(14)** | **(25)** |
| **Distributable cash flow** | **93** | 33 | 28 | 28 | 30 | **119** | **127** | **149** | **170** | **186** |
| DCF per unit | **$1.66** | $0.52 | $0.43 | $0.45 | $0.45 | **$1.85** | **$1.84** | **$1.97** | **$2.08** | **$2.14** |
| Cash distribution declared per unit | **$1.26** | $0.34 | $0.35 | $0.35 | $0.36 | **$1.40** | **$1.53** | **$1.68** | **$1.82** | **$1.94** |
| *% sequential distribution growth* | | *3.0%* | *2.2%* | *1.4%* | *1.4%* | | | | | |
| *% yr/yr distribution growth* | *5.0%* | *13.3%* | *12.1%* | *10.2%* | *8.3%* | *10.9%* | *9.5%* | *9.5%* | *8.4%* | *6.7%* |
| Distribution coverage | **1.3x** | 1.5x | 1.2x | 1.3x | 1.3x | **1.3x** | **1.2x** | **1.2x** | **1.1x** | **1.1x** |
| Excess cash flow | **21** | 11 | 6 | 6 | 7 | **30** | **21** | **22** | **22** | **17** |
| **% of total cash distribution** | | | | | | | | | | |
| General partner | **2.0%** | 2.0% | 2.1% | 2.3% | 2.5% | **2.2%** | **3.8%** | **6.1%** | **8.6%** | **12.9%** |
| Limited partners | **98.0%** | 98.0% | 97.9% | 97.7% | 97.5% | **97.8%** | **96.2%** | **93.9%** | **91.4%** | **87.1%** |
| Maximum potential distribution (MPD) | **$1.57** | | | | | **$1.69** | **$1.76** | **$1.86** | **$1.95** | **$2.04** |
| **Capital expenditures** | | | | | | | | | | |
| Maintenance capex | **16** | 4 | 6 | 6 | 7 | **24** | **29** | **36** | **43** | **50** |
| Growth capex | **5** | 2 | 2 | 8 | 8 | **20** | **20** | **20** | **20** | **20** |
| Acquisitions / "Dropdowns" at the end of the quarter | **112** | 254 | 0 | 0 | 100 | **354** | **350** | **350** | **350** | **350** |
| **Total capex** | **133** | 260 | 8 | 15 | 115 | **398** | **399** | **406** | **413** | **420** |
| **Credit and operating metrics** | | | | | | | | | | |
| Equity issuances *($ in millions)* | **128** | 13 | 0 | 0 | 50 | **63** | **175** | **175** | **175** | **175** |
| Total debt *($ in millions)* | **175** | 385 | 367 | 375 | 433 | **433** | **582** | **756** | **928** | **1,105** |
| Debt/cap | **16.6%** | 29.0% | 27.7% | 28.3% | 30.3% | **30.3%** | **34.4%** | **37.9%** | **41.1%** | **43.4%** |
| Debt/annualized EBITDA | **1.7x** | 2.6x | 2.6x | 2.6x | 2.8x | **3.0x** | **3.3x** | **3.4x** | **3.4x** | **3.5x** |
| Debt/ TTM EBITDA | **1.7x** | 3.3x | 2.9x | 2.8x | 3.0x | **3.0x** | **3.3x** | **3.4x** | **3.4x** | **3.5x** |
| EBITDA/interest expense | **10.4x** | 10.3x | 7.9x | 8.0x | 6.7x | **8.0x** | **5.0x** | **4.6x** | **4.4x** | **4.3x** |
| Maintenance capex as a % of EBITDA | 15% | 11% | 18% | 18% | 18% | 16% | 16% | 16% | 16% | 16% |

Source: Partnership reports and Wells Fargo Securities, LLC estimates

## MLP Glossary Of Terms

**Available Cash Flow:** Available cash flow is the cash flow available to the common unitholders and the general partner.

**Backwardation:** A market condition in which future commodity prices are lower than spot prices. A backwardated market usually occurs when demand exceeds supply.

**Contango:** A market condition in which future commodity prices are greater than spot prices. The higher future price is often due to the cost associated with storing and insuring the underlying commodity.

**British Thermal Unit (Btu):** A unit of measurement for energy representing the amount of heat required to raise the temperature of one pound of water one degree Fahrenheit.

**Current Yield:** The current yield is calculated by taking the current declared quarterly distribution annualized and dividing it by current stock price.

**Dekatherm:** A dekatherm is a measurement of energy content. One dekatherm is the approximate energy content of 1,000 cubic feet of natural gas (or 1 Mcf).

**Distributable Cash Flow (DCF):** DCF is the cash flow available to be paid to common unitholders after payments to the general partner.

**Distribution (Dividend) Discount Model (DDM):** DDM is an equity valuation tool used to estimate the present value of a stock based on the expected distributions (or dividends/future cash flow) received from the company.

**Distribution:** In a typical partnership agreement, the MLP is required to distribute all of its "available cash." MLPs typically distribute all available cash flow (i.e. cash flow from operations less maintenance CAPEX) to unitholders in the form of distributions (similar to dividends). However, management typically has some discretion in how much cash flow they choose to pay out.

**Distribution Coverage Ratio:** The coverage ratio indicates the cash available for distribution for every dollar to be distributed. The ratio is calculated by dividing available cash flow by distributions paid. Investors typically associate as the "cushion" a partnership has in paying its cash distribution. In this context, the higher the ratio, the greater the safety of the distribution.

**Dropdown:** A dropdown is the sale of an asset from the parent company (or sponsor company) to the underlying partnership. Dropdowns can also be defined as a transaction between two affiliated companies.

**Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA):** EBITDA is a non-GAAP measure used to provide an approximation of a company's profitability. This measure excludes the potential distortion that accounting and financing rules may have on a company's earnings; therefore, EBITDA is a useful tool when comparing companies that incur large amounts of depreciation expense because it excludes these non-cash items which could understate the company's true performance.

**Earnings Per Unit (EPU):** An MLPs' EPU is synonymous with a C corp.'s earnings per share (EPS). EPU is calculated by dividing net income allocated to the limited partners divided by the weighted average units outstanding at the end of the period.

**EBITDA Multiple:** An EBITDA multiple is the expected return an acquisition or organic growth project is estimated to generate. For example, a $100 million investment at an 8x EBITDA multiple, would be expected to generate approximately $12.5 million of EBITDA on an annual basis (or a 12.5% return).

**Excess Cash Flow:** Excess cash flow is the cash flow that remains after distributions have been paid to common and subordinated unitholders and general partner.

**Fractionation:** Fractionation is the process that involves the separation of the NGLs into discrete NGL purity products (i.e. ethane, propane, normal butane, iso-butane, and natural gasoline).

**Frac Spread (also known as "Processing Margin"):** The processing margin is the difference between the price of natural gas and a composite price for NGLs on a BTU-equivalent basis.

**General Partner (GP):** The GP (1) manages the day-to-day operations of the partnership, (2) generally has a 2% ownership stake in the partnership, and (3) is eligible to receive an incentive distribution (through the ownership of the MLPs' incentive distribution rights).

**Incentive Distribution Rights (IDRs):** IDRs allow the holder (typically the general partner) to receive an increasing percentage of quarterly distributions after the MQD and target distribution thresholds have been achieved. In most partnerships, IDRs can reach a tier wherein the GP is receiving 50% of every incremental dollar paid to the LP unitholders. This is known as the 50/50 or "high splits" tier.

**Limited Partner (LP):** The LP (1) provides capital, (2) has no role in the MLPs' operations or management, and (3) receives cash distributions.

**Liquid Petroleum Gases (LPGs):** LPGs are created (as a byproduct) during the refining of crude oil or from natural gas production. LPGs are typically a mixed form of propane and butane.

**Maintenance Capital Expenditures (CAPEX):** Maintenance CAPEX is the investment required to maintain the partnership's existing asset.

**Natural Gas Liquids (NGLs):** NGLs are extracted from the raw natural gas stream into a liquid mix (consisting of ethane, propane, butane, iso-butane, and natural gasoline). The NGLs are then typically transported via pipelines to fractionation facilities.

**Organic Growth Capital Expenditures (CAPEX):** Organic CAPEX is investments used to expand a company's operating capacity or operating income over the long-term.

**Processing:** Natural gas processing involves the separation of raw natural gas into "pipeline quality" gas and natural gas liquids.

**Tax Deferral Rate:** A percentage of the cash distribution to the unitholder that is tax deferred until the security is sold. The tax deferral rate on distributions ranges from 40-90%. The tax deferral rate is an approximation provided by the partnership and is only effective for a certain period of time.

## Energy Industry Abbreviations

**Bbls:** Barrels

**Bcf/d:** One billion cubic feet per day

**MBtu:** One thousand Btus.

**Mcf:** One thousand cubic feet of natural gas.

**MBbls:** One thousand barrels.

**MBbls/d:** One thousand barrels per day.

**MM:** In millions.

**MMBbls:** One million barrels.

**MMBbls/d:** One million barrels per day.

**MMBtu:** One million Btus.

**MMBtu/d:** One million Btus per day.

**MMcf:** One million cubic feet of natural gas.

**MMcf/d:** One million cubic feet of natural gas per day.

**Tcf:** One trillion cubic feet of gas.

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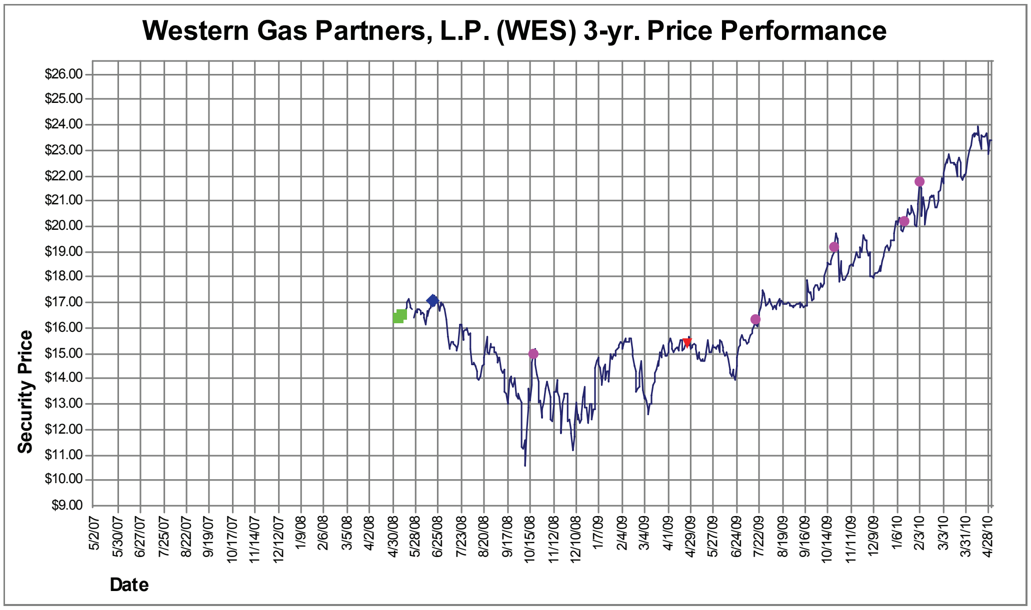


| | Date | Publication Price ($) | Rating Code | Val. Rng. Low | Val. Rng. High | Close Price ($) |
|---|---|---|---|---|---|---|
| ❐ | 5/9/2008 | | IPO at $16.50 | | | |
| | 6/18/2008 | | Lui | | | |
| ◆ | 6/18/2008 | 17.03 | 1 | 19.00 | 21.00 | 17.09 |
| ● | 10/20/2008 | 14.64 | 1 | 15.00 | 17.00 | 15.00 |
| ▼ | 4/24/2009 | 15.69 | 2 | 15.00 | 17.00 | 15.35 |
| ● | 7/16/2009 | 16.09 | 2 | 16.00 | 18.00 | 16.32 |
| ● | 10/22/2009 | 19.01 | 2 | 18.00 | 20.00 | 19.16 |
| ● | 1/15/2010 | 20.00 | 2 | 19.00 | 22.00 | 20.22 |
| ● | 2/3/2010 | 20.86 | 2 | 21.00 | 23.00 | 21.79 |

Source: Wells Fargo Securities, LLC estimates and Reuters data

**Symbol Key**

| | | | |
|---|---|---|---|
| ▼ | Rating Downgrade | ◆ | Initiation, Resumption, Drop or Suspend |
| ▲ | Rating Upgrade | ■ | Analyst Change |
| ● | Valuation Range Change | ❐ | Split Adjustment |

**Rating Code Key**

| | | | |
|---|---|---|---|
| 1 | Outperform/Buy | SR | Suspended |
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