

Electro-energy industry

28 Jan 2013

Otherwise stable operations slowed down by the global economic crisis

(HRK 000)	2009	2010	2011	9M2011	9M2012
Sales revenues	621,633	689,681	673,071	535,154	462,944
EBITDA	51,934	53,859	47,669	37,677	29,104
EBIT	34,662	37,549	32,038	25,764	22,881
Net income	32,811	37,117	33,649	23,358	19,722
EpS (HRK)	256.7	254.8	131.6	91.4	77.2
EBITDA margin	8.3%	7.8%	7.1%	7.0%	6.2%
Profit margin	5.2%	5.4%	5.0%	4.4%	4.2%
ROIC	39.0%	85.8%	29.3%	-	-
ROE	23.8%	23.0%	18.7%	-	-
P/E*	7.5	6.7	7.4	-	-
P/S*	0.4	0.4	0.4	-	-
EV/S*	0.4	0.4	0.2	-	-
EV/EBITDA*	4.6	4.6	3.1	-	-
Neto dug/EBITDA	-0.2	-1.9	-0.6	-	-

* Multiples and ratios are calculated based on market price @ 16 Jan 2013

Koncar distributivni i specijalni transformatori d.d. is a company primarily involved in **production of liquid-filled distribution transformers and medium power transformers**, which are also segmented in the organizational structure into two separate profit centers.

In 9M12, total sales level dropped 13.5% compared to the same period last year, with **the domestic market rising 2.6% YOY**, while **the foreign market generated 17.2% YoY lower sales**.

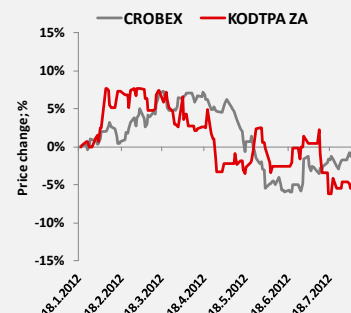
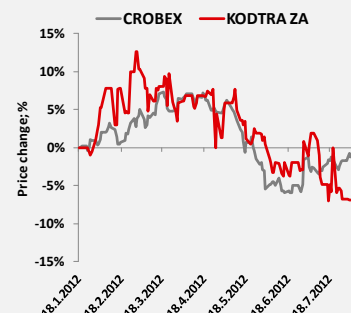
Company's balance sheet is rather stable, albeit non-current assets increased due to investment into expansion of research, production and office facilities. Namely, on 8 June 2011 a HRK 60m contract has been signed on the construction of a high voltage laboratory for testing mid size energy transformers up to 100 MVA and 170 kV, along with the expansion of production, storage and office facilities with the according equipment. Total value of this project is HRK 86m, of which 50% is financed with own resources, while the other half in amount of HRK 44.6m is a loan, representing the majority of the company's debt.

If we compare KODT's earnings and multiples with the peer group, we can see all companies are of the similar size, whereby **KODT records somewhat lower profitability at EBITDA level (7.1%) compared to the peer group median (8.4%), but higher at the bottom line (5.0% compared to 1.3% peer group median).** In terms of ROE and ROA, KODT fares pretty well and is substantially better compared to the peer group with ROE at 19% and ROA at 7.5%, while peer group median amounts to 3.2% and 2.3% respectively.

Potentials for KODT in the next ten years are clearly visible, however due to strong competition it is hard to estimate the potential realization. KODT has developed its presence in EMEA that offers a lot of potential and if the company manages to retain its presence in the following years when the investments cycle starts rolling, it will surely prosper.

GENERAL SHARE INFORMATION

Bloomberg ticker	KODTRA ZA KODTPA ZA
Number of shares	194,188 61,428
Market capitalization (HRK m)	247.3
1Y high/low (HRK)	1,150.00 / 900.00 1,079.99 / 850.00
1Y average daily turnover (HRK 000)	60.1 37.8
Free Float	27.09% 90.74%
Index member	NO
Website	www.koncar-dst.hr



Tomislav Bajić

Head of Research

Tel. +385 1 4825 858

tomislav.bajic@intercapital.hr

Krešo Vugrinčić

Junior Analyst

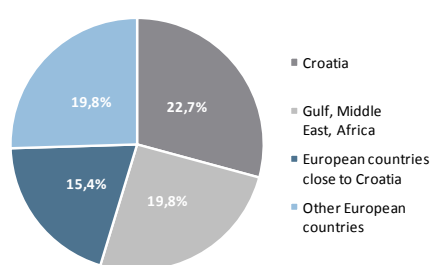
Tel. +385 1 4825 864

kreso.vugrincic@intercapital.hr

Business operations of Koncar D&ST

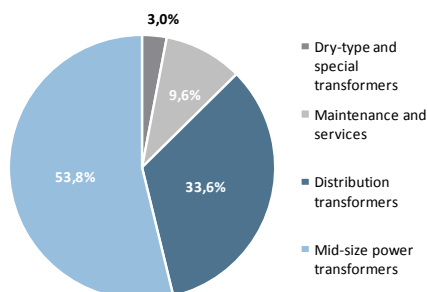
Koncar distributivni i specijalni transformatori d.d. is a company primarily involved in production of liquid-filled distribution transformers up to 2.5 MVA in power and 36kV in voltage and medium power transformers 2.5-100 MVA in power (producing transformers with power up to 100 MVA will be enabled in the new facility that should be in operation by the end of the year; current capacity is 63 MVA) and 170kV in voltage, which are also segmented in the organizational structure into two separate profit centers. Distribution transformers account for 34% of sales, whereas medium power transformers cover 54%. In addition to these two groups of products, the company also offers dry-type and special transformers but their aggregate share in sales amounts to only 3%.

Figure 1 Sales across markets (2011.)



Source: KODT

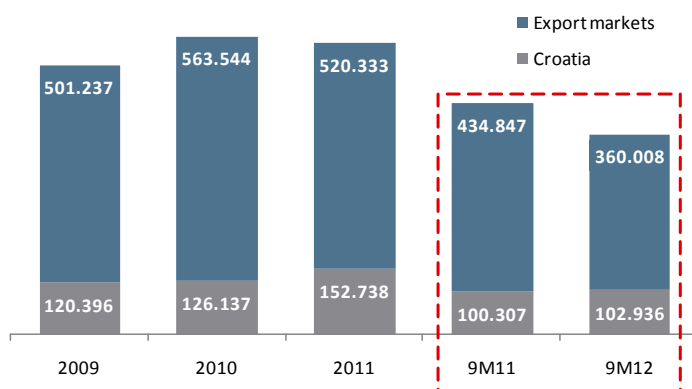
Figure 2 Sales across products (2011.)



Source: KODT

Koncar D&ST recorded sales revenues in amount of HRK 673.1m in 2011 (2.4% drop compared to 2010), whereby HRK 520.3m (77%) is accounted for by export markets, while the domestic market recorded sales of HRK 152.7m (23%). However, in the period 2009-2011 domestic sales grew at 12.6% CAGR, while foreign sales inclined at only 1.9% CAGR, albeit we have to mention that the majority of domestic sales is accounted for buy a single buyer HEP and therefore sales movement is a reflection of HEP's investment and maintenance plans. In 9M12, total sales level dropped 13.5% compared to the same period last year, with the domestic market rising 2.6% YOY, while the foreign market generated 17.2% YoY lower sales. KODT's most important buyers are electricity companies (around 80%), industrial companies and engineering companies realizing turnkey projects (hydro power plants, thermal power plants...).

Figure 3 Sales realized on the domestic and export markets (HRK 000)

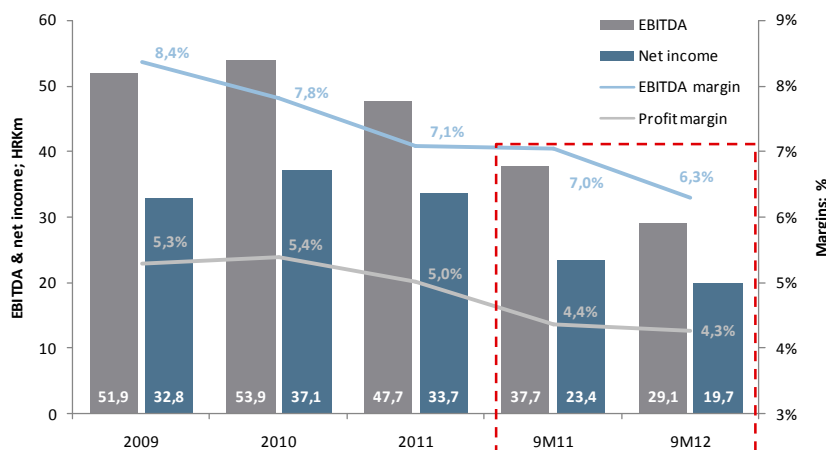


Source: KODT

In 2011, Koncar D&ST generated HRK 617.6m of COGS. Considering two most important parts of a transformer are tin construction and copper coil, the key materials required for production are these two. The company buys copper on the London Metal Exchange where it, after closing a deal, orders the necessary amount of copper at term prices one year ahead, in order to hedge from price fluctuations. In addition to this type of protection, there is a sliding contract option pegged to copper price changes, albeit this type of contract is rarely used as most buyers prefer a fixed price (which doesn't have to be more favorable for the buyer as it includes the estimated rise in copper prices). Transformer tin is not traded on any commodities exchange and there are only a few producers out there that operate in a type of oligopoly. KODT's procurement functions in a way that the company asks for bids a year upfront and closes the deal with the most favorable bidder for deliveries in the following year at a fixed price.

Even though sales revenues rose at 4.1% CAGR in the period 2009-2011, EBITDA recorded a declining trend of -4.2% CAGR in the same period. End of 2011, EBITDA amounted to HRK 47.1m which is 11.5% lower YoY, even though sales dropped only 2.4% in the same period. These levels resulted in 7.1% EBITDA margin in 2011, while the margin stood at 7.8% in 2010. If we compare 9M12 and 9M11, the EBITDA drop is even more significant as it amounted to HRK 29.1m in 9M12 (6.3% EBITDA margin) which is a 22.8% YoY decline. Net income in the period 2009-2011 climbed at 1.3% CAGR, albeit 2011 reached a 9.3% YoY lower net income at HRK 33.7m. These levels resulted in a profit margin of 5% in 2011, while 2010 level reflected a 5.4% margin. In 9M12 the drop is even steeper as the company generated HRK 19.7m net income (4.3% profit margin) which is 15.6% less YoY and it confirms the slightly declining trend in profitability the last couple of years, under the influence of the global economic crisis which stopped infrastructure investments on which KODT's operations are largely dependent.

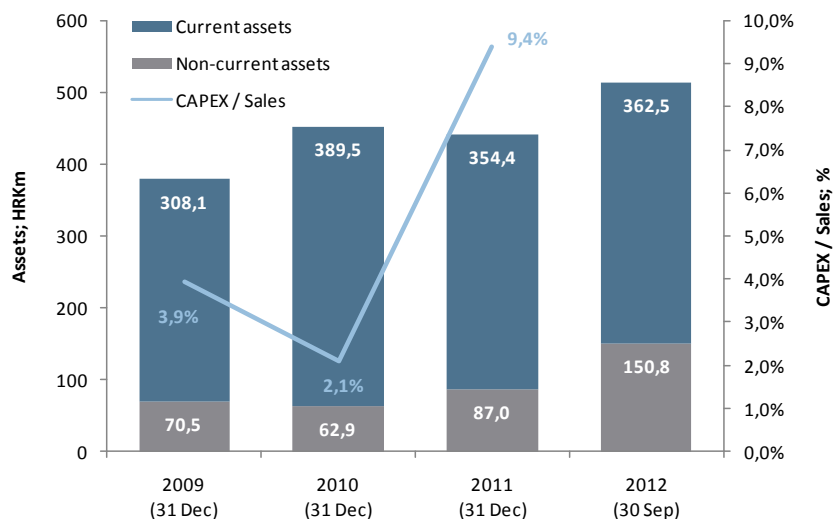
Figure 4 EBITDA and net income movement with according margins (HRKm)



Source: KODT, InterCapital Research

Company's balance sheet is rather stable, albeit non-current assets increased due to investment into expansion of research, production and office facilities. Namely, on 8 June 2011 a HRK 60m contract has been signed on the construction of a high voltage laboratory for testing mid size energy transformers up to 100 MVA and 170 kV, along with the expansion of production, storage and office facilities with the according equipment. Total value of this project (construction part, electric part and equipment) is HRK 86m, of which 50% is financed with own resources, while the other half in amount of HRK 44.6m is a 10 year loan with a 2-year grace period and interest rate of 4%.

Figure 5 Asset structure movement and investment ratio (HRKm)



Source: KODT, InterCapital Research

Due to the aforementioned loan, the company's net debt increased to trailing level of 0.6x EBITDA (end of September 2012 net debt amounted to HRK 22.6m), while the level before this loan had been negative. This investment will bring tax savings in the next (max) 10 years up to an aggregate value of 40% of total investment. Provisions, mostly for warranties and for protection against faults in an entire batch of products, are a significant position in the balance sheet as they amount to HRK 134.8 (26% provisions/assets).

Figure 6 Equity, liabilities and net debt movement (HRKm)



Source: KODT, InterCapital Research

*2012 ttm EBITDA

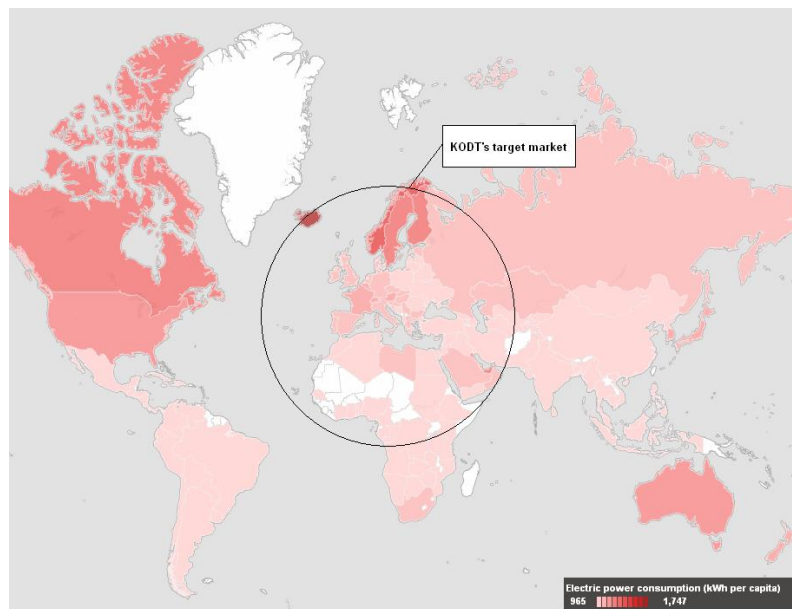
Market position

Today we decided to briefly attend the company Koncar Distributivni i Specijalni Transformatori (KODT), whose core business is production of electric transformers. The very nature of this business implies dependence on trends in electricity consumption, thereby also needs for infrastructure development. Considering KODT exports over 80% of its sales, mostly to EMEA, the company's operations are largely dependent on regional investment plans.

In Picture 1 we can see KODT's target market, along with electricity consumption per capita. At first glance we can already see that Eastern Europe and Africa consume a lot less electricity due to underdeveloped economies. An underdeveloped economy means an underdeveloped industry that consumes less energy. Also, underdeveloped industries use old-fashioned production facilities that use a lot of fossil fuels emitting high volumes of CO₂ which will have to be substantially reduced in the future and therefore loads of industrial facilities are crossing to gas or electricity. In addition, with the development of the economy, the living standard increases and the population starts using more and more electric appliances such as air-conditioning which contributes substantially to the increase of electricity consumption. This strong energy demand also affects the demand for infrastructure and therefore Africa needs estimated USD 43bn yearly investments in generation, transmission and distribution of energy.

The Western Europe is economy-wise far in front of Eastern Europe and Africa, but that means that the power grids developed a lot sooner, specifically in the 50's and 60' meaning it is time for reconstruction and modernization considering the life span of such equipment amounts to around 50 years and that such old-fashioned equipment produces a lot more losses.

Picture 1 Electricity consumption (kWh per capita)



Source: worldbank.org

According to data from the European Commission, the reconstruction of the European electric grid requires around EUR 200bn investments. However, it is expected that by 2020 the realized volume of investments will reach only slightly above 50% of the needed amount. In other words, in the next 10 years investments into the electric grid should amount to around EUR 100bn or EUR 10bn per year on average (average investments per year in the period 2005-2009 amounted to EUR 6bn). Among these investments, the majority should be

invested in the economically most advanced countries due to their aging infrastructure. This amount could increase up to EUR 140bn, if the process of getting construction permits and positive eco studies improves, as well as if extra funds could be raised through public-private partnership in order to mitigate portion of the risk from the public sector. Realization of these investments through interstate cooperation is necessary as localized solutions could be up to 20% more expensive, in addition to 750,000 new jobs along with extra EUR 19bn that would be added to the European GDP in the period up to 2020. According to some estimates, the entire MENA region could get around EUR 740bn of investments into energy infrastructure until 2017.

Table 1 Expected investments into electricity grid across countries until 2022

EURbn		EURbn	
Austria	1.1	Ireland	3.9
Belgium	1.9	Latvia	0.4
Bosnia & Herzegovina	0.0	Lithuania	0.7
Bulgaria	0.2	Luxembourg	0.3
Croatia	0.2	Montenegro	0.4
Czech Rep.	1.7	Holland	3.3
Cyprus	0.0	Norway	6.5
Denmark	1.4	Poland	2.9
Estonia	0.3	Portugal	1.5
Finland	0.8	Romania	0.7
France	8.8	Serbia	0.2
Macedonia	0.1	Slovakia	0.3
Germany	30.1	Slovenia	0.3
Greece	0.3	Spain	4.8
Hungary	0.1	Sweden	2.0
Island	0.0	Switzerland	1.7
Italy	7.1	Great Britain	19.0
Total		104.0	

Source: ENTSO-E, Ten-Year Network Development Plan 2012

If add the fact that electricity consumption (energy in general) is highly correlated with population growth, which should slow down a bit in the next ten years, but still grow significantly in African countries (2.3% per year), the potential for growth in the sector of generation, transmission and distribution of electricity, where production of transformers is an integral part, can easily be seen.

Table 2 Estimated population growth

	Yearly growth rate in %		Additional millions
	2002-2011	2012-2021	2021-2012
World	1.2	1.0	678
Africa	2.4	2.3	233
Lat. Am. and the Caribbean	1.2	1.0	55
North America	0.9	0.8	27
Europe	0.2	0.1	7
Asia and the Pacific	1.1	0.9	345
China	0.5	0.3	43
India	1.5	1.2	160
Developed Oceania	1.6	1.2	3

Source: UN World Population Prospects

Potentials for KODT in the next ten years are clearly visible, however due to strong competition it is hard to estimate the potential realization. KODT has developed its presence in EMEA that offers a lot of potential and if the company manages to retain its presence in the following years when the investments cycle starts rolling, it will surely prosper.

Peer group comparison

Considering KODT exports over 80% of its sales and is present on the global transformers market, the peer group includes companies with global sales headquartered on three continents. The companies are North American Hammond Power Solutions and Pioneer Power Solutions, Chinese company SanBian Sci-Tech and Slovenian company Kolektor Etra.

Hammond Power Solutions is one of the largest North American transformers producers. It manufactures a range of standard and specialized dry-type transformers. In addition, the product palette contains liquid-filled transformers whose buyers are mostly utility companies. Along with transformers manufacturing, the company also offers maintenance and repair services.

Pioneer Power Solutions manufactures liquid-filled and dry-type distributive and special transformers on six locations in the US, Canada and Mexico, with the biggest buyers being utility, industrial and construction companies. In addition to the products, the company offers complete practical solutions in all phases of electricity transmission and distribution.

SanBian Sci-Tech is a Chinese company located in the province of Zhejiang, manufacturing mid-size and large transformers. The company offers a wide range of products including 12 serial products and over 160 modifications, among which are dry-type transformers, combined transformers, special transformers and others.

Kolektor Etra is a Slovenian company specialized in manufacturing energy and generator transformers with power up to 500 MVA and voltage up to 420kV. In addition to manufacturing, the company also offers maintenance and repair services for transformers from various producers, including home-based and field work. Contrary to other companies included in the peer group, Kolektor Etra is not listed.

Table 3 Peer group analysis

Company Name	Revenue (EURm)	EBITDA (EURm)	Net income (EURm)	EBITDA margin	Profit margin	ROE	ROA	P/E	P/B	EV/S	EV/EBITDA
Hammond Power Solutions	160.9	13.1	4.4	8.1%	2.7%	6.7%	4.7%	8.9	1.0	0.4	4.6
SanBian Sci-Tech	114.6	1.0	-3.1	0.9%	0.0%	-7.0%	-2.7%	N/A	2.0	1.2	N/A
Pioneer Power Solutions	49.5	4.3	0.0	8.7%	-0.1%	-0.4%	-0.2%	9.8	2.2	0.7	8.7
Kolektor Etra	47.9	6.4	4.2	13.4%	8.7%	16.9%	6.0%	Not listed			
Average	93.2	6.2	1.3	7.8%	2.8%	4.0%	2.0%	9.3	1.8	0.8	6.7
Median	82.0	5.4	2.1	8.4%	1.3%	3.2%	2.3%	9.3	2.0	0.7	6.7
KODT	89.7	6.4	4.5	7.1%	5.0%	19.0%	7.5%	8.2	1.3	0.4	6.9

* multiples calculated on ttm basis @ 16 Jan 2013

Source: Bloomberg, InterCapital Research

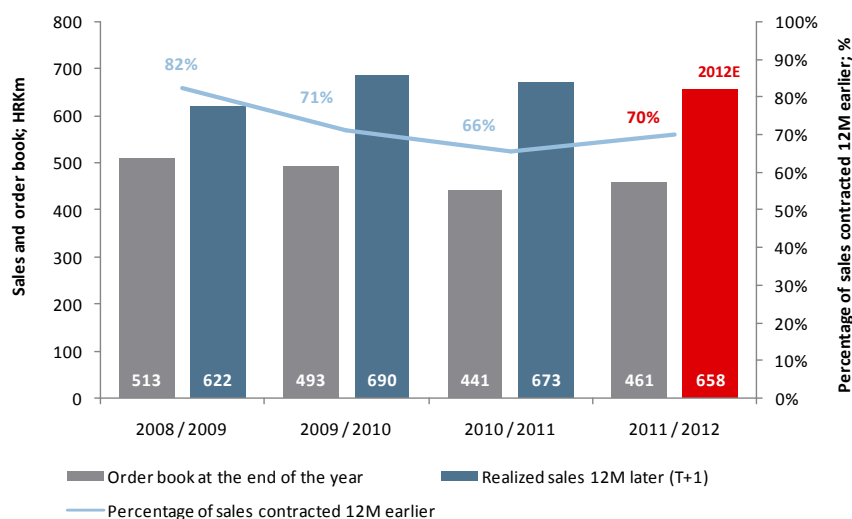
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favorable (increased energy consumption, high level of planned investments in expansion and modernization of electric power grids) and KODT is strongly present on foreign markets, this somewhat lower valuation surely seems attractive for investors. However, low liquidity and small market cap are a negative burden in that sense.

Outlook

Looking at odds for the company in shorter term, the best indicator is the order book, especially considering this business is characterized by known orders almost a year upfront. If we analyze the order book a couple years back, we see that 60-80% of sales had been arranged 12 months earlier. By taking into consideration the average percentage of order book/next-year-sales ratio in the last three years and adjust it a bit due to a declining trend, we can estimate 2011 order book (HRK 460.7m) accounts for 70% of sales in 2012. This analysis implies 2012 sales revenues for the company at HRK 658.2m (down -2% YoY), which is in line with management expectations whose estimates include sales and margins at last year's levels.

Figure 7 Realized sales revenues compared to order book balance 12M earlier (HRKm)



Source: KODT, InterCapital Research

As far as investments go, the company plans to finish the new laboratory project and to purchase a machine worth EUR 1m in 2013. Management's guidance on future dividend payouts includes maintaining current ratio of 40% net income.

Even though we see a positive outlook for the company in the long run, in the next couple of years there could be further stagnation or slight drops in sales and margins caused by the global economic crisis, which lowered public and private investments across the globe, while a complete turnaround is still quite far away. In addition, we have to mention political turmoil in North Africa that could significantly impact Koncar D&ST's operations, as these countries represent significant markets for the company and their dynamic of investments into energy infrastructure is questionable until the business environment stabilizes. Payment risks are also present in countries with uncertain political and legal environment.

Competitive pressure is also an important factor that influences operations of every company in the sector. Transformer market is generally in most target export markets close to the full competition pattern or a form of mild oligopoly, and the market pressure on majority of target markets is very strong. The entire transformer industry has been through major changes in the recent 10-20 years with a number of restructurings, winding-ups of

plants, opening of new plants, takeovers and mergers (consolidations) and the trends are continuing. In the several recent years, there has been a prominent trend of increase of production capacities in the transformer industry, especially in Asia where companies are lifting product quality standards in addition to extremely competitive pricing which could result in substantial pressure on European and US producers' margins in the future.

Price volatility of main materials used in production (copper, transformer tin, steel...) also represents an operational risk, albeit the company successfully dealt with those risks through the already mentioned procurement via forward contracts on the London Metal Exchange, in addition to yearly contracts with suppliers.

As the company operates on various markets and a lot of sales revenues come from exports, the company is exposed to exchange rate risks from which it protects itself via forward contracts with banks, in addition to y internal methods of harmonization of currency inflow and outflow.

Finally, we would like to mention transactions with related members of the Koncar Group, whereby HRK 40m of 2011 revenues were generated in-house. In those kinds of transactions there are always risks of unknown transfer prices.

Income statement (HRK 000)				Balance sheet (HRK 000)			
	2009	2010	2011		2009	2010	2011
Sales revenues	621,633	689,681	673,071	Non-current assets	70,534	62,853	86,996
Total operating revenues	625,313	693,476	675,132	Tangible assets	67,556	60,191	83,375
COGS	445,058	504,205	498,622	Intangible assets	516	200	1,159
Personnel expenses	77,997	83,839	90,738	Financial assets	2,462	2,462	2,462
Other operating expenses	50,324	51,573	38,103	Current assets	308,367	390,068	354,629
Operating expenses	573,379	639,617	627,463	Inventory	158,617	136,593	122,051
EBITDA	51,934	53,859	47,669	Trade receivables	70,098	82,176	97,101
Depreciation	17,272	16,310	15,631	Financial assets and other receivables	51,426	58,870	97,549
EBIT	34,662	37,549	32,038	Cash and cash equivalents	28,226	112,429	37,928
Net financial result	-476	1,387	4,979	TOTAL ASSETS	378,901	452,921	441,625
EBT	34,186	38,936	37,017	Total equity	138,146	161,171	179,750
Net extraordinary income	0	0	0	Share capital	38,342	76,685	76,685
Profit before tax	34,186	38,936	37,017	Reserves and retained earnings	66,993	47,368	69,413
Income tax	1,375	1,819	3,368	Net income from the current year	32,811	37,118	33,652
Net income before m.i.	32,811	37,117	33,649	Total long-term liabilities	105,703	128,354	140,554
Minority interests	0	0	0	Provisions	94,598	119,935	134,831
Net income	32,811	37,117	33,649	Long-term debt	11,105	8,419	5,723
				Other long-term liabilities	0	0	0
				Total current liabilities	135,052	163,396	121,321
				Accounts payable	46,740	50,089	64,090
				Short-term debt	8,470	3,508	3,577
				Other current liabilities	79,842	109,799	53,654
				TOTAL LIABILITIES AND EQUITY	378,901	452,921	441,625
Operating activities ratios				Cash flow (HRK 000)			
	2009	2010	2011		2009	2010	2011
Profitability ratios				Net income from the current year		37,117	33,649
Increase / decline of sales		10.9%	-2.4%	Depreciation		16,310	15,631
EBITDA margin	8.3%	7.8%	7.1%	CF from operating activities before Δ WC		53,427	49,280
EBIT margin	5.5%	5.4%	4.7%	Financial assets		-7,444	-38,679
Profit margin	5.2%	5.4%	5.0%	Trade receivables		-12,078	-14,925
Efficiency ratios				Inventory		22,024	14,542
Collection period in days	41	43	53	Accounts payable		3,349	14,001
Inventory period in days	130	99	89	Other liabilities		55,294	-41,249
Payables period in days	38	36	47	Net CF from operating activities		114,572	-17,030
Other ratios				Net purch. of tang. and intang. assets		-8,629	-39,774
ROA	1.0%	9.8%	7.4%	Net CF from investment activities		-8,629	-39,774
ROE	23.8%	23.0%	18.7%	Dividends paid		-14,093	-15,073
ROIC	39.0%	85.8%	29.3%	Minority interests		0	0
CROCI	1.2%	27.6%	47.3%	Increase/decrease in interest-bearing		-7,648	-2,627
Equity ratio	87.6%	93.1%	95.1%	Net CF from financing activities		-21,741	-17,700
Net debt in HRK 000	-8,651	-100,502	-28,628	Net increase/decrease in cash and equiv.		84,202	-74,504
Current ratio	2.28	2.39	2.92	Cash and equivalents beginning of the year		28,226	112,429
Net debt / EBITDA	-0.17	-1.87	-0.60	Cash and equivalents end of the year		112,428	37,925
P/E	7.5	6.7	7.4				
P/S	0.4	0.4	0.4				
EV/S	0.4	0.4	0.2				
EV/EBITDA	4.6	4.6	3.1				

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Fundamental rating values of an Issuer are given according to the following scale:

Sell - equities with expected absolute value decrease in the monitored time period

Hold - equities with expected absolute revenue of 0%-10% in the monitored time period

Buy - equities with expected absolute revenue of 10%-20% in the monitored time period

Strong buy - equities with expected absolute repayment of more than 20% in the monitored time period

4th Quarter (1 October - 31 December 2012)			
	Number	Percentage	Companies to which InterCapital Securities Ltd. provided investment banking services in the last 12 months
Strong Buy	5	27.8%	
Buy	2	11.1%	
Hold	7	38.9%	VIRO-R-A
Sell	1	5.6%	
Under Review	3	16.7%	DLKV-R-A
	18		

Any investments indicated in the report constitute risk, are not readily available in all jurisdictions, can be illiquid and may not be suitable for all investors. Value or income

realized on any one investment mentioned in the report may vary. If a financial instrument is denominated in a currency other than an investor's currency, a change in exchange rates may adversely affect the investment. Past performance is not necessarily indicative of future results. Investors must make their own informed investment decisions without depending on this Recommendation. Only investors with sufficient knowledge and expertise in financial dealings who are able to evaluate risk and return may consider investing in any form of securities or markets indicated herein.

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InterCapital Securities Research contacts

Tomislav Bajić, Head of Research, +385 (0)1 4825 858, tomislav.bajic@intercapital.hr

Morana Bauer, Analyst, +385 (0)1 4825 867, morana.bauer@intercapital.hr

Krešo Vugrinčić, Junior Analyst, +385 (0)1 4825 864, kreso.vugrincic@intercapital.hr