Is The Cord Really Being Cut?
Update on “The Controversy”

This note is co-authored by Nomura’s Media and Cable & Satellite teams and provides an updated look at the leading industry controversy known simply as “cord cutting”.

- The continued rise of Netflix’s subscriber count is offered as compelling evidence that U.S. consumers have traded their pay TV subscriptions for a cheaper internet-delivered substitute. With each new Netflix quarterly sub additions, the “cord cutting” chorus grows louder and louder. However, it is the shared view of our Media and Cable & Satellite teams that Netflix’s sub growth and the growth of U.S. pay TV homes are not mutually exclusive.

- We believe that the aggregate 4Q results from pay TV operators will show renewed growth again in U.S. television subscribers. Although 2010 will go down in history as the slowest growth in pay TV history, we think the weak demand is a function of two distinct trends: 1) New 2010 subscriber growth appeared to be significantly pulled forward in 2009 due the mandated shutdown of the analog TV spectrum which forced consumers to find new alternatives to their old “rabbit ears”; 2) 2010 subscriber growth was also likely impacted by a sharp slowdown in average new home formation in 2009 and 2010 which came in about 1 million homes lower than 2004 through 2008.

- As Time Warner Cable just reported, 4Q10 also surprisingly showed an increase in premium movie subs for the first time in almost three years. It seems illogical that consumers are dropping pay TV for online movie streaming but also signing up for more TV-Delivered film content.

- Despite the slower overall 2010 basic subscriber net additions, the pay TV ecosystem still appears very healthy for content owners. Rising programming costs at a cable MSO like Time Warner Cable now represent only 38% of video revenues and are being absorbed by growth in high margin DVR sales and new phone/broadband customers. The tipping point for rising programming costs seems many years away.

- On the content side, program and network owners admit that their online distribution views are evolving. While we believe that “the horse is out of the barn” for the film industry as the Epix and Starz/Encore deals clearly show, TV content owners appear to view the web as another window for lower valued catalog TV series, not new more valuable first run content. In fact, important TV content buyers like Turner and leading broadcast stations are threatening to reduce their spending on new syndicated TV series that have been too frequently streamed online. We also see the likely evolution of Hulu as a sign of positive evolution.

See Appendix A-1 for analyst certification and important disclosures. Analysts employed by non-US affiliates are not registered or qualified as research analysts with FINRA in the US.
Despite All the Hype... We Think the Pay TV Universe Is Still Growing

As Nomura launched coverage of both the media and cable & satellite sectors over the past few months, we couldn't help but notice that cord-cutting was a central controversy for both sectors.

Yes, net additions of U.S. pay TV households did fall in the second quarter of 2010. In fact, pay TV subscribers declined in 2Q10 by 56,000 and grew anemically by 33,000 in the 3rd quarter, while Netflix steadily experienced accelerated subscriber growth with net additions 1mn and 1.9mn over the same time periods (see Fig. 1 and 2). Thus, one data point had to be caused by the other.

Further fueling this debate was the strengthening of the Netflix streaming offer as they signed content deals over the back-half of 2010 with traditional media owners like Epix, NBC Universal and Disney (see Appendix at the end of report for show level detail). By all measures, Netflix had a very successful 2010.

However, it is the joint view of both our media and telecom teams that the subscriber declines of 2010 were likely the result of two distinct factors: 1) The 2009 conversion from Analog to Digital Broadcasting which pulled forward subscriber demand from 2010; 2) The Reduction in New Housing Formation caused by economic forces which limited new subscriber growth (see Fig. 4).
From 2004 to 2008, there was about 1 million annual average of organic video subscribers. In 2009, at the height of the recession, that number DOUBLED to over 2 million. Yes, doubled as the analog signal was shut down, forcing new consumers into the market for a digital broadcast receiver. We estimate that net sub additions will only total 199,000 in 2010 – about a million below average. That million appears to have been pulled forward in 2009.

Also, note that from 2004 to 2008, household formation easily averaged over 1 million households per year. In 2009 and 2010, household formation totaled a decline -143,000 and 203,000, respectively.

With this as background, we continue to believe that cord-cutting is an overstated risk to the television industry and we believe that data points are lining up to support that position. For example, in the 4th quarter, Netflix added 3 million new subscribers – the largest subscriber addition quarter on record. However, despite this growth, we believe that the U.S. multichannel industry will again add subscribers in the 4th quarter.

So far, we have had three video distributors report: Time Warner Cable, Verizon’s FiOS and ATT’s U-Verse. In aggregate, these three companies reported 287,000 net subscriber additions in 4Q10 – almost in line with the 4Q09 total of 291,000.
It is our belief that the industry will grow pay TV subs in the 4th quarter. For the companies with enough public disclosure to track, we forecast net additions of 130,000 subscribers. We expect media companies will likely speak on their earnings calls on total 4Q and 1Q subscriber trends before we hear from Comcast and DISH in the latter half of the reporting season.

New Subscribers More Profitable for Media Companies
The growing video subscribers at the Telcos are much more profitable for the media companies. Telcos’ subscribers have increased their share of the total pay TV subscriber universe from 1% back in 4Q07 to an estimated 7% in 4Q10 (see Fig. 6 and 7). We believe telcos pay roughly 20-30%+ premiums in affiliate fees relative to the larger cable operators, helping provide an incremental lift to cable network’s affiliate fee growth. This mix shift is playing out with little fan-fare among investors but it helps maintain strong affiliate fee growth despite the slow sub growth.

**Fig. 6: 4Q07 Subscribers Breakdown**
![4Q07 Subscribers Breakdown](image)

**Fig. 7: 4Q10E Subscribers Breakdown**
![4Q10E Subscribers Breakdown](image)

Source: Company data, Nomura research

Bounce Back in Premium Subscribers
Another interesting data point … Despite the decline in Time Warner Cable video customers and the rise of Netflix, Time Warner Cable actually reported GROWTH in premium movie subscribers to services like HBO, Showtime, and Starz/Encore.

Rob Marcus, COO of Time Warner Cable from 4Q earnings call: “In addition, there was some signs of life in the Pay-TV category as we added 77,000 pay units. That’s the first growth in pay units we experienced in ten quarters.”

If folks were cutting the cord, it is hard to understand why premium movie subscriptions went up. However, we will wait to hear from our media companies to help determine how much of this growth was driven by promotional subscribers vs. new paying subscribers.

The Only Thing to Fear Is…Stupidity Itself
While our Nomura cable and telecom team presents evidence that the slowdown in U.S. pay TV homes was a function of both accelerated growth in 2009 and fewer new home formations in 2010, the Nomura media team believes that the media industry will limit the deflationary flow of premium content to web aggregators.

On this count, we are seeing some positives (... and also some negatives) that support this point of view. After speaking with a number of key executives in charge of purchasing some of the most important off-network syndicated television content, it is clear they are not interested in paying previously established prices for content that’s been over-exposed on the web. For example, at an industry event earlier this year, Phil Kent, Chairman & CEO of Turner Broadcasting, summarized the industry view with:

“much heightened sensitivity to what the long term affect of having top tier syndicated programming on SVOD services could have and we’ve are telling our suppliers, the various studios that we buy from, that in the future this is going to have a significant
impact on what we’re going to be willing to pay for programming, or even bid at all on certain programming.”

Second, Hulu’s partners, according to reports in the Wall Street Journal, is re-examining their current business model of allowing premium content to run nearly day and date with limited commercial interruption as News Corp President & COO Chase Carey suggested earlier on the last earnings call:

“Obviously in places like Hulu, we’ve talked about a subscription service to go with the pay service. I think as we go forward with our traditional distribution partners, it’s important we deal with these issues constructively. We think the digital arena is a very important one.”

During the same earnings call, Mr. Carey also went on to explain the evolving content landscape and his thinking on online rights management:

“But look, scarcity of our product is of tremendous value. We need to make sure we manage that product, we manage its availability intelligently and I think that’s very much a work in progress and I certainly wouldn’t say today we’ve got a set of rules in place that we’re looking to as long-term rules. I think we learn as we go and I think those practices will continue to evolve.

No “bad deals”- unintended consequence of Comcast-NBCU merger conditions

Third, the CMCSA-NBCU merger concessions won’t foster online growth as new entrants could be discouraged given the price of entry and we believe that peer media companies understand the ramifications of short term deals. We refer to such deals as “bad deals.” While this is clearly a positive to the cable business model, it does not alleviate the needs for programmers to seek profit maximization through new distribution models. While this was likely not the original intention of the FCC, ultimately media companies that are dependent on the traditional affiliate fee models will have a diminished incentive to sell programming to online distributors such as Netflix.

While NBCU will technically have to offer its full suite of linear programming to online providers, we believe the economics and requirements for carriage of competing content make the reality of such an undertaking economically unrealistic. Under such a scenario, an online provider would need to fully compensate Comcast the full bundled rate (including minimums and foregone advertising) of not only the Comcast/NBCU content, but also that of another broadcast network who either by itself or in combination with additional programming partners provide 55% of an online providers content (as measured by hours provided not ratings). For such a scenario to become a reality and dilutive to content profits, we believe we would need to see the combination of deals with either CBS, FOX or ABC, along with either Turner or Viacom agree to sell a portion of their networks at rates below their current rate cards. Given the dependence on affiliate fees, we view such a confluence of events as unlikely.

We think the future of Comcast and the status quo of the pay TV model comes down to the discipline of NBCU’s direct programming competitors. It is our interpretation that the merger conditions shift the responsibility onto others to not do bad deals, rather than directly force Comcast to put programming online. The reason is that every “comparable content” bad deal will compel a corresponding bad deal from NBCU, which thus further enhances the video alternative to traditional pay television. In such a scenario, the FCC conditions require Comcast-NBCU to match the economics and content profiles of existing or future programming deals between programming peers and online video providers. Within the context of this report, we believe this is the key condition to focus on.

As a result of the comparable content rules, we expect that Comcast will begin to offer Sprout to Netflix given the comparability to Disney’s content currently being offered online. Also, we expect to see select portion of the legacy NBC Broadcast Library provided to Netflix. Finally, Comcast will have to continue to offer the existing content to Hulu and will likely have to rent shows on iTunes. That said, and as we previously stated, we believe that this condition actually decreases the incentive for content providers to make future online programming deals, given the high likelihood that NBCU programming will likely be offered along side. It is our understanding that some of the
early “experimental” deals were brokered with the intention of fostering audience and momentum of hit programming. We see this as less attractive given the dilutive nature of the FCC conditions.

However, while the above data-points are indeed positive, the industry appears to still be wrestling with a couple of lagging issues. First, according to sources we interviewed, the broader TV Everywhere roll-out is going slowly due to rights issues and technological delays. Second, the hope of another Netflix-like bidder, which would drive up the price of online content, does not appear to be imminent.

Trying to Not Make Same Mistakes Internationally

With all the controversies in the U.S., we believe the major international content owners will be more cautious with their online rights after having the luxury of watching the quickly evolving U.S. landscape over the past year. In our view, the international markets are more difficult to conquer, given some of the technological limitations and multiple pay TV providers in each market.

Different pay TV providers are bidding up the rights for U.S. content allowing hit programs to receive as much as 4x their initial deal prices for exclusive rights to help differentiate programming offerings, which should drive subscriber growth. Andy Kaplan, President of Networks at Sony Pictures Television summarized the rising content costs at NATPE: “Programming costs are escalating at a pretty good rate, and that’s a function of the growing popularity and demand for U.S. shows as well as the kinds of programs we tend to buy.”

Our Conclusion: Pay TV Companies Still Have Dollars to Spend

We believe that pay TV companies still have room to spend. Taking a look at TWC’s financials, though content revenues have slowed to a 1% CAGR over the 2007-2010 time period, non-content revenues from set-top boxes and DVRs have shown healthy growth. Programming costs at TWC represents only 38% of revenues compared to other content distribution businesses such as theatres where content is 50% of revenue (see Fig. 8). Also, rising content costs at Time Warner Cable are also easily absorbed by growth in much higher services like broadband and phone. In 2010, the change in content costs equaled 28% of the total change in broadband and phone revenues.

When looking at these numbers, we also question why the broadcast networks have not focused on receiving a share of the quickly growing DVR revenue stream. Broadcast networks account for 56% of the DVR viewing in the current TV season (see Fig. 10) with CBS (at 18% of all DVR usage) generating the greatest share vs. its peers. Given broadcast’s growing presence on the DVR, we believe they should think about sharing in this revenue as part of future negotiations.
Fig. 10: DVR Lift STD A18-49 at Broadcast and Cable Nets

<table>
<thead>
<tr>
<th>Average Viewers* (000s)</th>
<th>DVR Viewing</th>
<th>Contrib.</th>
</tr>
</thead>
<tbody>
<tr>
<td>CBS Broadcast</td>
<td>856</td>
<td>17.9%</td>
</tr>
<tr>
<td>FOX Broadcast</td>
<td>655</td>
<td>13.7%</td>
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<tr>
<td>ABC Broadcast</td>
<td>633</td>
<td>13.2%</td>
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<tr>
<td>NBC Broadcast</td>
<td>550</td>
<td>11.5%</td>
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<tr>
<td>Viacom</td>
<td>429</td>
<td>9.0%</td>
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<tr>
<td>NBC Universal Cable</td>
<td>379</td>
<td>7.9%</td>
</tr>
<tr>
<td>Independent</td>
<td>306</td>
<td>6.4%</td>
</tr>
<tr>
<td>Discovery</td>
<td>207</td>
<td>4.3%</td>
</tr>
<tr>
<td>Time Warner</td>
<td>181</td>
<td>3.8%</td>
</tr>
<tr>
<td>News Corp. Cable</td>
<td>165</td>
<td>3.4%</td>
</tr>
<tr>
<td>Disney Cable</td>
<td>163</td>
<td>3.4%</td>
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<tr>
<td>Scripps Networks</td>
<td>88</td>
<td>1.8%</td>
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<tr>
<td>Comcast Cable</td>
<td>83</td>
<td>1.7%</td>
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<tr>
<td>Cablevision</td>
<td>70</td>
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<tr>
<td>Crown</td>
<td>10</td>
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<td>Radio One</td>
<td>6</td>
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<tr>
<td>Liberty</td>
<td>2</td>
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<tr>
<td>Total</td>
<td>4,784</td>
<td>100.0%</td>
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Source: Nielsen Media, Nomura research

**Bundled economics facilitate demand for content and resultant price escalation**

It is both our Media and Cable & Satellite team’s belief that 7-9% annual programming expense increases are a reality, given the intensely competitive nature of the video distribution business. This coincides with the media team’s view on an increasing percentage of video subscription revenues likely being absorbed by programming costs over time. With four operators established in most markets, we believe competition will increase from already high levels, with product offerings defined by price competition and incremental video services offered at little or diminishing margins. In such an environment, as long as one or more parties in a market has an ability to compete on differentiated content, we believe there will be a sustained necessity for distributors to pay up and remain competitive. The bundled offerings of Cable and Telecom’s provide a distinct advantage over DBS, in our view, so long as DIRECTV and DISH Network desire to remain competitive and grow subscribers.

To be clear, we do not view eroding video margins as a positive influence to incremental investment in Cable or DBS stocks. However, we think it is important for investors to understand the inherent advantage of the cable business model’s ability to absorb programming costs relative to that of DBS. We believe that in an environment where cable is losing 2% of its video subscribers with half flowing to DBS, DBS would need to raise price by an extra 200bps just to hold margins flat (see Fig. 11). Our estimates contemplate 4% broadband subscriber growth and 2% voice subscriber growth.

While we often hear the threats from video distributors, namely the DBS providers, we disagree that the distribution model cannot support higher costs of content. That said, single product video offerings are inherently flawed without the ability to consistently raise price.
Fig. 11: The Single-product Nature of DBS Makes Balancing Margin Preservation and Programming Cost Increases Difficult

$ per subscriber data

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<th>Static video Subscribers</th>
<th>Cable</th>
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<th>Cable</th>
<th>DBS</th>
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<td>Video inputs</td>
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<tr>
<td>Video ARPU</td>
<td>$77.00</td>
<td>$77.00</td>
<td>$77.00</td>
<td>$77.00</td>
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<tr>
<td>Video programming cost per subscriber</td>
<td>$32.00</td>
<td>$32.00</td>
<td>$32.00</td>
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<tr>
<td>Annual video subscriber (loss)/gain</td>
<td>0.0%</td>
<td>0.0%</td>
<td>(2.0%)</td>
<td>1.0%</td>
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<tr>
<td>Annual video programming price increase</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
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<tr>
<td>Broadband</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Broadband penetration of video subs</td>
<td>65.0%</td>
<td>65.0%</td>
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<td>Broadband ARPU</td>
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<td>Incremental penetration of video subscribers</td>
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<tr>
<td>Broadband cost per subscriber</td>
<td>$2.50</td>
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<tr>
<td>Voice</td>
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<td>Voice penetration of video subs</td>
<td>35.0%</td>
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<tr>
<td>Voice ARPU</td>
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<td>Incremental penetration</td>
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<tr>
<td>Voice cost per subscriber</td>
<td>$6.00</td>
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<td>Revenue and margins year 1</td>
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<tr>
<td>Service revenue per video subscriber</td>
<td>$117.90</td>
<td>$77.00</td>
<td>$116.55</td>
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<td>Total Revenue</td>
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<td>$1,399</td>
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<tr>
<td>Total direct costs</td>
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<td>$384</td>
<td>$429</td>
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<tr>
<td>Gross margin</td>
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<td>$540</td>
<td>$970</td>
<td>$540</td>
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<td>Revenue and margins year 2</td>
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<td>Service revenue per video subscriber year 2</td>
<td>$120.36</td>
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<td>Incremental revs per sub</td>
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<td>$2.79</td>
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<td>Incremental revs in total</td>
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<td>$0</td>
<td>$19</td>
<td>$9</td>
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<tr>
<td>Total direct costs</td>
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<td>$415</td>
<td>$456</td>
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<td>Gross margin</td>
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<td>$509</td>
<td>$961</td>
<td>$514</td>
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<td>Incremental gross margin</td>
<td>($3.84)</td>
<td>($30.72)</td>
<td>($8.54)</td>
<td>($25.63)</td>
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<tr>
<td>Incremental margin per video subscriber</td>
<td>($0.32)</td>
<td>($2.56)</td>
<td>($0.72)</td>
<td>($2.11)</td>
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| Price increase needed to hold margin flat | 0.27% | 3.32% | 0.60% | 2.75% |

Source: Nomura estimates
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<tr>
<th>Date</th>
<th>Company</th>
<th>Window</th>
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<td>Multi-year deal, first-run theatrically released films</td>
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<td>9/8/2010</td>
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<td>Long-term deal, first-run theatrically released films</td>
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<td>8/10/2010</td>
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<td>90 Days after Pay TV window</td>
<td>EPX library, 5 yr deal</td>
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<td>7/15/2010</td>
<td>Time Warner</td>
<td>Instant</td>
<td>Deal includes all prior seasons to Nip/Tuck, Veronica Mars, Pushing Daisies and Terminator: The Sarah Connor Chronicles among others</td>
</tr>
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Appendix A-1

Analyst Certification

We, Michael Nathanson and Michael McCormack, hereby certify (1) that the views expressed in this Research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.
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As at 31 December 2010.
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STOCKS
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A rating of ‘Reduce’, indicates that the analyst expects the stock to underperform the Benchmark over the next 12 months.
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Explanation of Nomura’s equity research rating system for Asian companies under coverage ex Japan published from 30 October 2008 and in Japan from 6 January 2009

STOCKS
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A ‘Buy’ recommendation indicates that potential upside is 15% or more.
A 'Neutral' recommendation indicates that potential upside is less than 15% or downside is less than 5%.

A 'Reduce' recommendation indicates that potential downside is 5% or more.

A rating of 'Suspended' indicates that the rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Nomura is acting in an advisory capacity in a merger or strategic transaction involving the subject company.

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Explanation of Nomura's equity research rating system in Japan published prior to 6 January 2009 (and ratings in Europe, Middle East and Africa, US and Latin America published prior to 27 October 2008)

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A 'Neutral' stance, indicates that the analyst expects the sector to perform in line with the Benchmark during the next six months.
A 'Bearish' stance, indicates that the analyst expects the sector to underperform the Benchmark during the next six months.

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Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published prior to 30 October 2008

STOCKS
Stock recommendations are based on absolute valuation upside (downside), which is defined as (Fair Value - Current Price)/Current Price, subject to limited management discretion. In most cases, the Fair Value will equal the analyst's assessment of the current intrinsic fair value of the stock using an appropriate valuation methodology such as Discounted Cash Flow or Multiple analysis etc. However, if the analyst doesn’t think the market will revalue the stock over the specified time horizon due to a lack of events or catalysts, then the fair value may differ from the intrinsic fair value. In most cases, therefore, our recommendation is an assessment of the difference between current market price and our estimate of current intrinsic fair value. Recommendations are set with a 6-12 month horizon unless specified otherwise. Accordingly, within this horizon, price volatility may cause the actual upside or downside based on the prevailing market price to differ from the upside or downside implied by the recommendation.
A 'Strong buy' recommendation indicates that upside is more than 20%.
A 'Buy' recommendation indicates that upside is between 10% and 20%.
A 'Neutral' recommendation indicates that upside or downside is less than 10%.
A 'Reduce' recommendation indicates that downside is between 10% and 20%.
A 'Sell' recommendation indicates that downside is more than 20%.

SECTORS
A 'Bullish' rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a positive absolute recommendation.
A 'Neutral' rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a neutral absolute recommendation.
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