



May 10, 2007

Price: EUR 12.25

Netherlands
[Integrated
Telecommunication]
 Bloomberg: [KPN NA]

Market Cap:
 EUR 22,645.00 m
Outstanding Shares:
 1,928.55 m
Six Month Avg.
Daily Trading Vol.
(EUR m): 137.35

52 Week High/Low:
 EUR 12.82 / EUR 8.47

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KPN TELECOM

BUY

CHANGE IN BUSINESS MODEL MOBILE PAYS OFF

- The upside from strong profits at the Mobile operations is more than compensating for the disappointment at Fixed. Following the Q1 results, we have modestly raised our EBITDA estimates. Combined with a lower tax rate we have raised our EPS estimates for 2007 from EUR 0.70 to EUR 0.75, for 2009 from EUR 0.84 to EUR 0.90 and for 2009 from EUR 0.91 to EUR 1.02. Following the increase in estimates our updated DCF model points to a 12-months price target of EUR 13.75 (raised from EUR 13.25). With a projected total return of more than 15% we reiterate our Buy recommendation.
- The change in business model is clearly paying off for Mobile – coupling a multi-brand market approach with a structural reduction of handset subsidies. KPN has proven to be very successful in combining market share gains, solid revenues growth and structural cost reductions, which is driving Mobile margins much higher than expected. Fueled by improving margins in Germany and the Netherlands we expect EBITDA from Mobile to jump 19% this year.
- Fixed was a clear disappointment with EBITDA 10% below our estimate in Q1. The higher-than-expected expenses to solve the problems related to the VoIP roll-out were an unpleasant surprise. Still, we expect this to be mainly an incidental issue. Apart from the VoIP issue, structural pressure on the traditional Fixed business continues to be fierce, with line losses worsening again in Q1. We have lowered our EBITDA estimates for Fixed by 6% for 2007 and by 4% for 2008.
- The investment case remains attractive, with the pressures at Fixed more than offset by growth and improving margins at Mobile. We expect free cash flow to remain comfortably above the target of EUR 2bn annually, resulting in an attractive FCFE yield of 10%. KPN has committed itself to pay out all free cash to shareholders: the risk of KPN making a large, overpriced acquisition is not too high in our view. We project further upside from the potential of KPN as a take-over target.

	Sales (EUR m)	EBITDA (EUR m)	Net Result (EUR m)	EPS (EUR)	PER (X)	EV/EBITDA (X)	Div. Yield (%)
2009E	12,195.00	5,132.00	1,775.00	1.02	12.01	5.72	4.57
2008E	12,137.00	4,989.00	1,628.00	0.90	13.64	6.14	4.41
2007E	12,088.00	4,864.00	1,411.00	0.75	16.40	6.52	4.25
2006A	12,112.00	4,837.00	1,584.00	0.79	13.63	6.19	4.64
2005A	11,936.00	4,717.00	1,437.00	0.65	12.95	6.21	5.31

Also view Auerbach Grayson Research on Reuters, Bloomberg, FirstCall, FactSet, and CapitalIQ

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10 May 2007

KPN Telecom
Fixed Line Communications

Buy
Unchanged

Reason to publish this report
Update

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Share price
EUR 12.25

Target share price
EUR 13.75

Perf: 1/3/12m (%)
-1.0 / 8.0 / 27.3

Market capitalisation
Euro 22,645 m

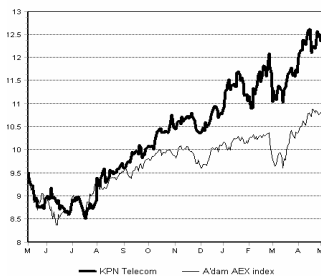
Outstanding shares
1,849 m (2007E)

Average daily volume
11.0 m

Company codes
Bloomberg: KPN NA
Reuters: KPN.AS

Major shareholders
Capital Group 7.4%
Capital Research 15.1%

Relative share price performance



Company profile

KPN offers telecom services to both consumers and businesses. Its core activities are telephony and data services through its fixed network in the Netherlands, and mobile telecom services in Germany (where it holds the number three market position), the Netherlands and Belgium and data services in Western Europe. To offset declines at the traditional revenues, KPN aims to grow its market share in the new IP and DSL markets.

www.kpn.com

Change in business model Mobile pays off

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- The investment case remains attractive, with the pressures at Fixed more than offset by growth and improving margins at Mobile. We expect free cash flow to remain comfortably above the target of EUR 2bn annually, resulting in an attractive FCFE yield of 10%. KPN has committed itself to pay out all free cash to shareholders: the risk of KPN making a large, overpriced acquisition is not too high in our view. We project further upside from the potential of KPN as a take-over target.

KPN Telecom: Key Financial Data

Financial year	2005	2006	2007E	2008E	2009E
Total revenues (EURm)	11,936	12,112	12,088	12,137	12,195
Adjusted EBITDA (EURm)	4,717	4,837	4,864	4,989	5,132
Adjusted EBITA (EURm)	2,348	2,224	2,338	2,629	2,814
EBITA margin (%)	19.7%	18.4%	19.3%	21.7%	23.1%
Adjusted net result (EURm)	1,437	1,584	1,411	1,628	1,775
Change (%)	-15.8%	10.2%	-10.9%	15.4%	9.1%
Reported EPS (EUR)	0.65	0.79	0.75	0.90	1.02
Adjusted EPS (EUR)	0.65	0.79	0.75	0.90	1.02
Change (%)	3.8%	20.8%	-5.5%	20.3%	13.5%
Dividend per ordinary share (EUR)	0.45	0.50	0.52	0.54	0.56
Dividend yield(%)	5.31%	4.64%	4.25%	4.41%	4.57%
Adjusted P/E	12.95	13.63	16.40	13.64	12.01
FCF yield (%)	13%	11%	10%	10%	11%
EV / Adjusted revenues	2.45	2.47	2.62	2.53	2.41
EV / Adjusted EBITDA	6.21	6.19	6.52	6.14	5.72
EV / Adjusted EBITA	12.48	13.47	13.57	11.66	10.43

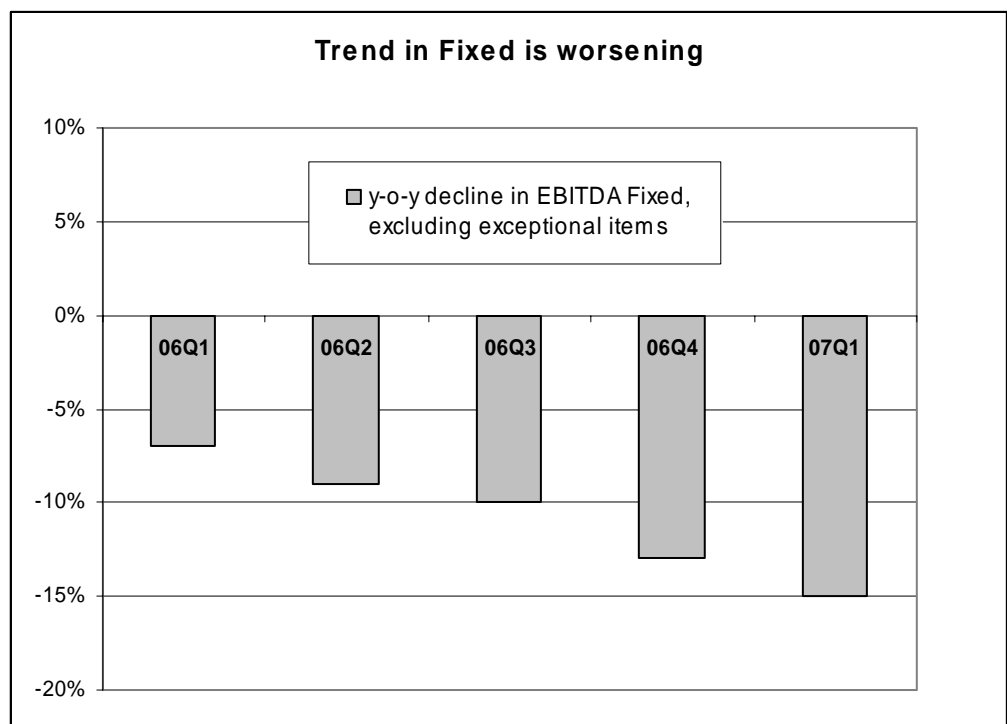
Source: SNS Securities Research

An unpleasant surprise in Fixed

Impact VoIP issues larger than expected

EBITDA for the traditional Fixed dropped 22% to EUR 574m (and a 15% decrease excluding exceptional items), which was nearly 10% below our estimate. The main reason for the shortfall was higher-than-expected expense to address the problems with the roll out of VoIP. The campaign to win new customers for the *Internetplusbellen* service was highly successful last year and resulted in some 250K additions in Q4. This increase was significantly more than the organization could handle and, combined with the relative complexity of the new technology, led to bottlenecks in properly and timely connecting new customers and addressing complaints. The company reacted by adding more engineers and increasing the capacity of the call centers, while complaining customers were offered financial compensation. This led to 'tens of millions' in additional expenses during Q1. At the same time, the order intake was lowered from 20K to 5K per week by significantly lowering marketing. KPN stated these additional expenses will continue into Q2 but at a lower level. The intake of new customers will not be accelerated before all quality issues are solved, which is expected before the end of Q2. KPN takes the right decision in our view to focus on fixing the quality problems, even if this is at the expense of short term profitability.

EBITDA Fixed fell 15% in Q1, impacted by incidental expenses to address VoIP problems



Mainly an incidental issue in our view

The problems with the VoIP roll-out were no surprise: they been extensively publicized in the Netherlands and KPN itself discussed this issue during the Q4 presentation last February. The fact that KPN at that time indicated that only 5% of new customers were experiencing problems and that management was on top of the issue, gave us the impression that it would not have a very substantial impact on results. While the shortfall in Fixed was fully offset by the strong performance of Mobile, we believe KPN could have been more explicit about the financial impact of the VoIP issues. Still, we are confident that the problems will have been largely fixed by the end of Q2 and that it is primarily an incidental issue, which does not impact the longer term outlook.

Overall trends continues to be a decline in Fixed

Apart from the incidental expenses which resulted in a worse than expected drop in Q1, the overall trend continues to be a decline. Main factor are the continued line losses, due to increased mobile-only households, cable competition while the migration from PSTN lines to relatively lower-priced VoIP subscriptions is also negatively impacting Fixed revenues. The trend in line losses accelerated again in Q1 to 140K compared to 130K in Q4. As of this year, alternative operators such as Tele2 are able to offer line rental on a wholesale basis. This led to an additional loss of 47K retail lines – although the financial impact from these losses is relatively modest – resulting in a total loss of 187K lines.

15% drop in full-year EBITDA expected

For the full year, we expect a 15% decline in EBITDA for Fixed. This includes a net negative impact of some EUR 90m related to the All-IP network, which will mostly impact the second half. As far as the full year impact from the All-IP transformation program is concerned, KPN forecasted EUR 100m-150m in restructuring expense plus EUR 50m to EUR 100m in project costs, which will be partly offset by some EUR 75m-150m in real estate gains (as the more efficient All-IP network will make a significant number of technical buildings redundant). Over the period 2007-2009, All-IP expenses are estimated at approximately EUR 550m and will be fully offset by a projected EUR 600m in real estate book gains.

Total operating revenues	07Q1A	07Q2E	07Q3E	07Q4E	FY06A	FY07E	FY08E	FY09E
E-Plus	698	774	820	819	2,894	3,112	3,271	3,446
KPN Mobile (NL)	759	796	825	803	2,980	3,183	3,201	3,301
BASE	152	161	162	166	622	641	705	755
Total Mobile	1,609	1,731	1,807	1,789	6,450	6,936	7,177	7,502
Fixed & Other	1,315	1,282	1,270	1,285	5,561	5,152	4,960	4,693
Total operating revenues	2,924	3,013	3,077	3,074	12,112	12,088	12,137	12,195

Source: KPN, SNS Securities Research estimates

Lowering estimates for Fixed

We have lowered our EBITDA estimates for Fixed by 6% to EUR 2,21bn for 2007, by 4% to EUR 2.26bn for 2008 and by 3% to EUR 2.25bn for 2009. While the additional expenses for VoIP are mostly incidental we expect some spill-over effects, such as additional capacity for the introduction of future new services (IPTV) to avoid a repeat of the problems with VoIP. In addition, we take a more conservative view on the impact from continued line losses. The year-on-year increase in EBITDA estimated for 2008 is due to the impact from All-IP expenses, which we project to turn from negative in 2007 to net positive in 2008 (although this is mostly dependent on the exact timing of the real estate gains). Excluding the All-IP impact, we expect the decline in EBITDA to moderate from 10% in 2007 to 5% in 2008 and 2% in 2009, as pressure on traditional revenues streams will be increasingly offset by ongoing cost savings and an increase in new services (IPTV).

Moreover, we expect Fixed to contribute a very steady operating free cash flow of EUR 1.4bn annually over the period 2007-2009, which includes the net expenses and investments for the All-IP program. The company remains confident that it will be able to reach agreement on a wholesale model for VDSL. This All-IP/VDSL is a key initiative to improve the performance of Fixed, as the new network will further lower costs and enable new broadband services and it will result in a more moderate competitive environment (assuming the wholesale model will be approved).

Change in reporting structure

Note that as of this year, KPN changed the reporting structure in line with the change in the organization: from Fixed and Mobile in the Netherlands to Consumer and Business. For this quarter, we decided to stick to the old reporting structure due to the limited history of financial figures under the new structure. In additional, the difference in business fundamentals continues to be mostly between Fixed and Mobile, as evidenced by the Q1 results.

Mobile continues to surprise on the upside

Changed business model paying off

The shortfall in Fixed is more than offset by much higher-than-expected margins in Mobile. E-Plus reported a margin of 36%, which was well ahead of expectations. The improved margin is driven by the organizational cost savings implemented last year, a reduction in subscriber acquisition expense and the leverage effect from increased scale and revenues. Despite the reduction in subscriber acquisition costs (mainly handset subsidies) E-Plus is successfully gaining market share, and growing revenues with tariff reductions offset by increased traffic volumes. The new labels – such as Base, Simyo and Ay Yildiz – continued their steady growth with again 800K new customers in Q1. The drop in the E-Plus label did not appear to stabilize in Q1 despite the new 10c offer (Zehnsation), which we expected to drive a recovery of the traditional label. This was however impacted by a clean up of inactive customers, which impacted post-paid net additions by some 200K in Q1. Adjusted for this impact the drop in E-Plus customers narrowed from 300K in Q4 to some 100K in Q1 according to our calculations. Services growth fell back slightly to 8% in Q1 from 10% in previous quarters, but this can be mostly explained by the VAT increase in Germany, which E-Plus did not pass through to its customers.

E-Plus structurally at a higher level of profitability

While KPN is not yet willing to increase the margin target of 30%+ for E-Plus, we do not see any reason why it should fall back sharply again in the short term. Apart from continued impact from the reduction in handset subsidies, the outsourcing of the network will have an additional impact in the remainder of the year. The steady improvement in margins over the past couple of quarters has been achieved in the face of price reductions announced by the competition. We have raised our EBITDA margin estimates to 35% for the next couple of years, compared to our previous estimate of 32%-33%. We expect a continued strong performance for E-Plus, as the challenger strategy targeted at fixed-to-mobile substitution is clearly working. In Belgium, KPN will incur a significantly negative impact from MTA reductions, but we expect Base to continue its solid EBITDA margins of close to 40%.

EBITDA	07Q1A	07Q2E	07Q3E	07Q4E	FY06A	FY07E	FY08E	FY09E
E-Plus	253	272	289	278	905	1,092	1,138	1,206
KPN Mobile (NL)	302	322	339	338	1,092	1,301	1,306	1,367
BASE	60	65	66	68	264	259	283	312
Total Mobile	615	659	694	685	2,235	2,653	2,727	2,885
Fixed & Other	574	569	540	528	2,602	2,211	2,262	2,247
EBITDA	1,189	1,228	1,234	1,213	4,837	4,864	4,989	5,132

Note that Fixed includes restructuring expense and real estate gains related the All-IP program

Mobile Netherlands the star performer

In addition to the strong margins at E-Plus, Mobile the Netherlands was the star performer last quarter. The strong improvement in margins at Mobile the Netherlands – up 5% compared to last year – has been boosted by the change in strategy to lower handset subsidies while driving growth through market segmentation, copying the elements of the strategy that brought the success in Germany and Belgium. Revenues grew 8% in Q1. While the growth rate is positively impacted by the postponement in new MTA reductions, we believe this is an impressive figure in a mature market like the Netherlands. While we already believed that a 40% EBITDA margin would be more appropriate for Mobile the Netherlands given its market share of 50% - we now see upside and we have raised our estimates accordingly.

Upside Mobile EBITDA

We have raised our total estimates for Mobile EBITDA by 9% to EUR 2.65bn for 2007, by 6% to EUR 2.73bn for 2008 and by 7% to EUR 2.89bn for 2009. Following delays in the decision making process, it is likely that the reduction in roaming tariffs will only start to have a more substantial impact as of 2008. Our estimates assume an initial negative impact of 3%-4% on KPN Mobile's EBITDA (with the tariff reduction partly offset by price elasticity).

Raising EPS estimates

At the group level, the increase in estimates for Mobile more than compensates for the reduction in Fixed EBITDA. Our total EBITDA estimates are modestly increased by 2% for 2007 to EUR 4.86bn and for 2008 by 1% to EUR 4.99bn (2009: +2% to EUR 5.13bn). Combined with a larger reduction in the tax rate than expected (to 23% from 27%) and only partly offset by higher-than-expected interest expense, we have raised our EPS estimates for 2007 from EUR 0.70 to EUR 0.75, for 2009 from EUR 0.84 to EUR 0.90 and for 2009 from EUR 0.91 to EUR 1.02.

Increase in price target

Buy rating reiterated

We have modestly increased our estimates for free cash flow and we expect a continued high level of more than EUR 2bn annually during the period 2007-2009. The increase in estimates leads to an increase in our valuation. Our updated DCF model points to price target of EUR 13.75, up from our previous target of EUR 13.25. We reiterate our Buy recommendation.

KPN DCF summary

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Perpetual	
EBITDA	4,864	4,989	5,132	5,197	5,093	4,991	4,891	4,793	4,697	4,604		
Capex	1,983-	1,557-	1,368-	1,393-	1,365-	1,338-	1,311-	1,285-	1,259-	1,234-		
Tax	538-	605-	647-	672-	659-	645-	632-	620-	607-	595-		
WC & provisions	14-	3-	36-	36-	35-	34-	34-	33-	32-	32-		
Free cash flow	2,329	2,825	3,081	3,096	3,034	2,973	2,914	2,856	2,799	2,743	30,961	
Year	0.67	1.67	2.67	3.67	4.67	5.67	6.67	7.67	8.67	9.67		
Discount factor	0.96	0.90	0.84	0.78	0.73	0.69	0.64	0.60	0.56	0.53	0.53	
	36,941	2,228	2,528	2,581	2,427	2,226	2,041	1,872	1,717	1,575	1,444	16,302
Risk premium	4.50%		NPV operations		36,941		Growth FCF '11-'16		-2%			
Risk free	4.25%		PV tax shield		1,261-		Terminal growth		-2%			
Beta	0.9		Net debt		9,100-							
Debt/capital	0.33		Pension deficit		1,200-							
Cost of debt	4.1%		Equity value		25,380							
Adj. tax rate	23%		# shares		1,925							
WACC	6.9%		12-month price target		13.76							

Source: SNS Securities Research estimates

KPN Telecom: Financial data

P&L STATEMENT (EUR m)	2004	2005	2006	2007E	2008E	2009E
Total revenues	11,851	11,598	11,448	11,437	11,488	NA
EBITDA	4,835	4,759	4,837	4,864	4,989	5,132
Depreciation	-1,933	-1,882	-1,829	-1,783	-1,753	-1,714
EBITA	2,899	2,348	2,224	2,338	2,629	2,814
Amortisation and impairment	-257	-494	-781	-743	-607	-604
EBIT	2,645	2,348	2,224	2,338	2,629	2,814
Interest result	-589	-547	-520	-509	-490	-480
Other financial result	0	0	0	0	0	0
Result from participations	1	13	7	8	10	11
Pre-tax result	2,057	1,814	1,711	1,837	2,149	2,345
Tax	-300	-360	-127	-423	-513	-560
Minorities	50	17	0	4	8	9
Other P&L items	0	0	0	0	0	0
Net result	1,707	1,437	1,584	1,411	1,628	1,775

ADJUSTED KEY P&L DATA (EUR m)	2004	2005	2006	2007E	2008E	2009E
Adjusted total revenues	11,819	11,936	12,112	12,088	12,137	12,195
% change		1%	1%	0%	0%	0%
Organic sales growth	-3%	0%	-1%	0%	0%	0%
Adjusted EBITDA	4,779	4,717	4,837	4,864	4,989	5,132
% change		-1%	3%	1%	3%	3%
Adjusted EBITDA margin	40.4%	39.5%	39.9%	40.2%	41.1%	42.1%
Adjusted EBITA	2,899	2,348	2,224	2,338	2,629	2,814
% change		-19%	-5%	5%	12%	7%
Adjusted EBITA margin	24.5%	19.7%	18.4%	19.3%	21.7%	23.1%
Adjusted net result	1,707	1,437	1,584	1,411	1,628	1,775
% change		-16%	10%	-11%	15%	9%
Adjusted net margin	14.4%	12.0%	13.1%	11.7%	13.4%	14.6%

PER SHARE DATA (EUR m)	2004	2005	2006	2007E	2008E	2009E
Outstanding shares (average), millions	2,385.42	2,212.91	2,011.98	1,888.55	1,812.19	1,740.74
Outstanding shares (year end), millions	2,329.40	2,095.40	1,928.55	1,848.55	1,775.82	1,705.65
Reported EPS	0.72	0.65	0.79	0.75	0.90	1.02
% change		-9%	21%	-5%	20%	14%
Adjusted EPS	0.63	0.65	0.79	0.75	0.90	1.02
% change		4%	21%	-5%	20%	14%
Free cash flow per ordinary share	0.96	1.10	1.20	1.22	1.17	1.38
% change		15%	9%	2%	-4%	17%
Dividend per ordinary share	0.35	0.45	0.50	0.52	0.54	0.56
% change		29%	11%	4%	4%	4%
Pay out ratio	56%	69%	63%	70%	60%	55%
Shareholders equity per share	2.63	2.29	2.09	1.93	NA	NA
Share price (latest or financial year end)	6.99	8.47	10.77	12.25	12.25	12.25

VALUATION	2004	2005	2006	2007E	2008E	2009E
Share price / Adjusted EPS	11.10	12.95	13.63	16.40	13.64	12.01
Share price / Book value	2.66	3.69	5.17	6.36		
Free cash flow per ordinary share / share price	14%	13%	11%	10%	10%	11%
Dividend / share price	5.01%	5.31%	4.64%	4.25%	4.41%	4.57%
Enterprise value / Adjusted revenues	2.06	2.45	2.47	2.62	2.53	2.41
Enterprise value / Adjusted EBITDA	5.10	6.21	6.19	6.52	6.14	5.72
Enterprise value / Adjusted EBITA	8.41	12.48	13.47	13.57	11.66	10.43

Source: Company data, SNS Securities Research estimates

BALANCE SHEET (EUR m)	2004	2005	2006	2007E	2008E	2009E
Intangible fixed assets	8,667	9,401	9,051	8,563	7,956	7,352
Tangible fixed assets	8,917	8,338	7,965	7,910	7,714	7,368
Financial fixed assets	1,840	1,440	1,154	1,031	1,031	1,031
Inventories	0	0	0	0	0	0
Trade debtors	2,639	2,314	2,255	2,246	2,237	2,228
Other current assets	0	0	0	0	0	0
Cash and cash equivalents	2,167	1,033	803	1,473	628	387
Total assets	24,230	22,702	21,258	21,223	19,567	18,366
Trade creditors	3,250	292	2,282	2,271	2,282	2,268
Other short term non-interest bearing debt	0	0	0	0	0	0
Short term interest bearing debt	2,272	5,316	642	1,934	1,604	2,218
Long term interest bearing debt	7,861	7,238	8,426	7,696	6,996	5,682
Provisions and other	4,436	3,945	4,787	4,745	4,423	4,103
Minority interests	145	28	1	15	7	-2
Shareholders equity	6,266	5,076	4,195	3,638	3,329	3,172
Total equity and liabilities	24,230	22,702	21,258	21,223	19,567	18,366

KEY BALANCE SHEET NUMBERS AND RATIOS	2004	2005	2006	2007E	2008E	2009E
Market capitalisation	16,282.5	17,748.0	20,770.5	22,644.7	21,753.8	20,894.2
Net debt (+)	7,966	11,521	9,190	9,082	8,897	8,438
Enterprise value	24,393	29,297	29,960	31,727	30,651	29,333
Capital employed	14,806	17,200	16,186	14,975	14,997	14,293
Capital employed (average)	14,844	16,003	16,693	15,581	14,986	14,645
Net working capital	-611	2,022	-27	-25	-45	-40
Net working capital / Adjusted total revenues	-5.2%	16.9%	-0.2%	-0.2%	-0.4%	-0.3%
Solvency	26.5%	22.5%	19.7%	16.8%	16.1%	15.4%
Net debt / Adjusted EBITDA	1.6	2.4	1.9	1.9	1.8	1.6
Adjusted EBITDA / Interest result	8.1	8.6	9.3	9.6	10.2	10.7
Adjusted EBITA / Interest result	4.9	4.3	4.3	4.6	5.4	5.9

CASH FLOW STATEMENT (EUR m)	2004	2005	2006	2007E	2008E	2009E
Operating profit after amortisation of goodwill	2,645	2,348	2,224	2,338	2,629	2,814
Depreciation and amortisation	2,190	2,376	2,610	2,526	2,360	2,318
Organic change in working capital	-127	16	-149	28	20	-5
Organic change in provisions	-63	-248	-292	-42	-23	-31
Financial income and expenses	-589	-547	-520	-509	-490	-480
Dividend from non-consolidated companies	0	0	0	0	0	0
Tax paid	0	0	0	-300	-812	-850
Other changes in free cash flow	-99	-112	198	0	0	0
Net capital expenditure	-1,668	-1,394	-1,650	-1,765	-1,662	-1,618
Free cashflow	2,289	2,439	2,421	2,275	2,022	2,149
Acquisitions and divestments	94	-812	-228	-218	105	250
Share issues / buy backs	-1,062	-1,697	-1,615	-1,000	-1,000	-1,000
Dividend paid	-796	-890	-982	-950	-942	-940
Change in interest bearing debt	-27	-312	-3,486	562	-1,030	-700
Other changes in cash flow	0	-793	0	38	105	250
Change in cash and cash equivalents	498	-479	-3,890	670	-845	-241

Source: Company data, SNS Securities Research estimates

This report has been prepared by Victor Bareño

Changes in Recommendation

Date	Previous Recommendation	New Recommendation
12-02-2007	Hold	Buy

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Reduce	-15% to 0%	12 months
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