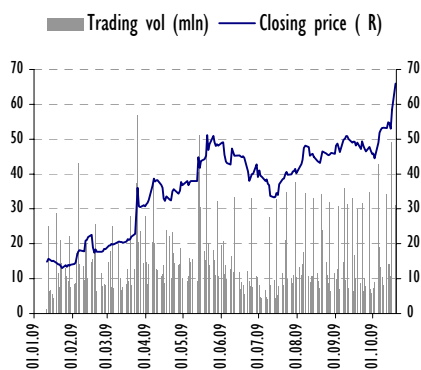


Rostelecom prefs: hitting the jackpot on Svyazinvest



Rostelecom prefs on MICEX



Source: Bloomberg

We see strong upside potential in Rostelecom prefs following the Svyazinvest reorganization. With a 67% spread to ords the stock now gives cheap exposure to the shares and cash flows of the new “national champion”. While future valuation parameters remain unknown to the market, we attempted to estimate Rostelecom prefs price at the merger using three scenarios. Our analysis resulted in R92 price benchmark per one preferred share or a 40% upside from current levels.

- ▶ **In late September the strategy committee under the Svyazinvest BoD approved the merger of 7 RTOs into Rostelecom.** Presumably, RTOs shareholders would be offered to convert their shares into new Rostelecom ords and prefs. All legal formalities concerning asset consolidation should be completed by March 2011. We note that uncertainty about asset valuation and swap ratios is likely to continue into 1Q10 causing continuing volatility in RTOs and Rostelecom shares.
- ▶ **The government is interested in a high valuation of Rostelecom ordinaries and less concerned about preferred stock.** While there is no doubt Rostelecom commons should get generous valuation during the merger with RTOs to secure a comfortable controlling majority in the new “national champion” for the government (i. e. a 51%+ stake), developing cash-based equivalent of preferred shareholders rights (i. e. discount to commons) always leaves enough room for an uncertainty. This is particularly relevant for the Rostelecom case, given that the government does not hold either a direct or an indirect stake in Rostelecom preferred shares.
- ▶ **The future valuation of Rostelecom preferred shares remains unknown** and a matter of some speculation. On the one hand, the current 67% discount to the common market price suggests strong appreciation potential (110% upside if the discount narrows to at least 30%). On the other hand, Rostelecom ordinary shares valuation is not fundamentally justified suggesting 9.2x on 2009F EV/EBITDA and 30.9x on P/E.
- ▶ **We used three different approaches to find out how Rostelecom prefs could be valued during the merger.** In our first valuation approach the size of the government’s stake in post-merger Rostelecom (common stock) and possible valuation of seven RTOs are the two major factors to determine Rostelecom prefs price. The second approach relies on the given price of Rostelecom commons (the purchase price of the 40% stake from KIT-Finance). We use conservative multiple-based approach as the third valuation method.
- ▶ **Our scenario analysis indicated R92 as a benchmark for one Rostelecom preferred share during the merger, or a 40% upside potential.** Our base case scenario suggests that during the merger seven RTOs are valued at \$5.3bn in total and Rostelecom – at \$3.2bn, which would allow the government to secure a 65% stake in the new company. At the same time, a 30% discount is applied to commons to determine the price of preferred share. The worst-case scenario suggests a 37% downside from the current market price and in the best-case scenario almost a threefold upside to R161.
- ▶ **Rostelecom prefs give exposure to new “national champion” dividends.** We believe the existing dividend policy of regional telecoms and Rostelecom would persist after the eight companies merge into one. Given the preliminary merger timetable, the new “national champion” would pay its first dividends in 2011. Under our base-case scenario, 40% of the new “champion’s” net profit could be attributable to the current holders of Rostelecom preferred shares. According to estimates, this would suggest a R6.3 dividend for 2010 and a 9% yield.
- ▶ **We see the following risks for upside realization in Rostelecom preferred shares:** 1) Svyazinvest reorganization would be postponed from 2010; 2) Reorganization might involve a different scheme (operational holding on the basis of Rostelecom instead of asset merger).

Rostelecom prefs - hitting the jackpot on Svyazinvest

In late September the strategy committee under the Svyazinvest BoD approved the underlying telecoms assets reorganization involving a merger of 7 RTOs into Rostelecom. Presumably, RTOs shareholders would be offered to convert their shares into new ordinary and preferred shares of Rostelecom. Should minority shareholders of any RTO block the merger with the long-distance operator, such company would become a part of the new Rostelecom holding; Svyazinvest would transfer its controlling stake in this RTO to Rostelecom in exchange for new shares, while a voluntary exchange offer could be made to RTO's minorities.

According to Svyazinvest timetable all legal formalities concerning asset consolidation should be completed by March 2011. The key reorganization milestones would be:

- 1) before March 2010 – asset appraisal and swap ratios determination;
- 2) March – May 2010 - negotiations with RTOs' minorities;
- 3) June – July 2010 – RTO EGMs on the merger;
- 4) 4) August – September 2010 – minority buyout.

Uncertainty about asset valuation and swap ratios is likely to continue into 1Q10 retaining RTOs and Rostelecom among volatile names. Svyazinvest engaged Ernst & Young to make an independent appraisal of the underlying telecoms assets, however it is not clear whether a new independent valuation of Rostelecom would coincide with the valuation of the seven RTOs. DCF should become the main valuation approach and be based on the 2009F RAS financials. Reportedly, a global investment bank would give a fairness opinion on Ernst & Young valuation before March 2010. Hence, RTOs and Rostelecom shares are likely to remain high risk during the next 6M until the uncertainty regarding future asset valuation ceases.

Rostelecom pref valuation remains a major piece of the merger puzzle. While there are some indications that RTOs minorities can bet on their shares appraisal not completely disregarding the company's fundamentals and breaking minorities' interests, the future valuation of Rostelecom prefs remains unknown and a matter for speculation.

We note two main pillars of the ongoing uncertainty about Rostelecom pref price: i) valuation of the company's common stock, which would be used to determine swap ratios, ii) the applied discount to commons. The current 67% discount to common market price, on the one hand, suggests strong appreciation potential (110% upside if the discount narrows down to at least 30%). On the other hand Rostelecom ordinary shares valuation is not fundamentally justified suggesting 9.2x on 2009F EV/EBITDA and 30.9x on P/E.

The government is interested in a high valuation for Rostelecom common shares and is less concerned about preferred stock. While there is no doubt that Rostelecom commons should get a generous valuation during the merger with RTOs to secure a comfortable controlling majority in the new "national champion" for the government (i. e. a 51%+ stake), developing cash-based equivalent of preferred shareholders rights (i. e. discount to commons) always leaves enough room for uncertainty. This is particularly relevant in the Rostelecom case, given that the government does not hold either direct or indirect stakes of Rostelecom preferred shares (unless some shares have been accumulated from the market prior to reorganization to secure positive voting on the merger). The latter suggests the government should not be concerned about new-Rostelecom preferred equity split between current RTK pref holders and RTOs pref holders, consequently, the preferred swap ratios.

We use three different approaches to find out how Rostelecom prefs could be valued in the merger:

- ▶ In our first valuation method the size of the government's stake in post-merger Rostelecom (common stock) and possible valuation of seven RTOs are two major factors to determine Rostelecom pref price
- ▶ The second approach relies on the given price of Rostelecom commons (the purchase price of a 40% stake from KIT-Finance)
- ▶ We use conservative multiple-based approach as the third valuation method.

1st valuation approach: RTKMP benchmark - R93 per one share

Key assumptions: the size of the government's stake in Rostelecom after the merger, possible RTOs' valuation.

Rostelecom pref price during the merger first and foremost rests upon the future valuation of the common shares of Rostelecom and RTOs so that two major goals can be achieved: 1) the government's stake of the common shares in the enlarged Rostelecom exceeds 51%; 2) RTOs valuation is attractive enough to incite minorities to vote for the merger. Possible outcomes here could be:

1) In our view, the government would like to secure the stake in Rostelecom commons of no less than 65% after the merger. Should recent speculations prove true that there will be a possible privatization (i. e. new-Rostelecom shares placement) in 2012, we believe the government's stake in Rostelecom should not fall to less than 65% (from current 90%) after the Syazinvest reorganization: on the one hand, at least 10–15% of the company should be placed to secure good stock liquidity, on the other, the government's stake should not drop below 51% after the placement.

2) Guessing the possible result of the independent DCF-based appraisal of RTOs makes no sense in our view, given the high degree of uncertainty over the base-case long term development scenario for the companies as well as key long term macroeconomic assumptions to be used by the appraiser in his financial model. We base our assumptions on key multiple metrics EV/EBITDA and P/BV to find a benchmark for RTOs valuation, which could satisfy minorities. Regional telecoms trade at 2.7–4.0x on forecast 2009 EV/EBITDA and at 0.4-1.3x on P/BV, which is cheap when compared to historical and current peer levels in emerging markets.

Regional telecoms comparative valuation

As of October 19, 2009	Price	Mcap	EV	EV/EBITDA			P/E			P/BV
				2008	2009F	2010F	2008	2009F	2010F	2009F
NW Telecom	0.42	373	900	2.8	3.4	3.0	41.8	7.5	5.8	0.4
Centertelecom	0.51	801	1,772	3.7	3.9	3.4	6.1	5.7	5.1	1.3
VolgaTelecom	1.84	454	1,100	2.6	2.7	2.4	7.7	5.7	4.3	0.6
Southern Telecom	0.07	213	1,021	3.7	4.0	3.5	57.4	7.6	4.3	0.9
Sibirtelecom	0.034	409	1,198	2.6	2.8	2.5	7.6	8.9	5.5	0.8
Uralsvyazinform	0.023	753	1,808	3.7	4.0	3.5	31.4	9.4	6.4	1.1
Far East Telecom	3.00	287	544	2.5	2.8	2.5	5.0	3.7	4.2	1.0
Seven RTOs average				3.1	3.4	2.9	22.4	6.9	5.1	0.9
Emerging markets avg.				4.9	4.7	4.6	9.5	10.7	9.9	N. A.
Developed markets avg.				5.4	5.3	5.3	14.1	11.5	10.6	N. A.
RTOs premium/(discount) to emerging peers				-36%	-27%	-35%	137%	-35%	-49%	N. A.
RTOs premium/(discount) to developed peers				-43%	-36%	-44%	59%	-40%	-52%	N. A.

Source: Bloomberg, Gazprombank

Regional telecoms historical EV/EBITDA

	2005 avg.	2006 avg.	2007 avg.	2008 avg.	2009F	2005-2007 average	Current discount to 2005-2007 average
NW Telecom	4.5	5.6	5.0	4.5	3.4	5.0	-33%
Centertelecom	5.6	4.2	4.7	3.3	3.9	4.7	-16%
VolgaTelecom	4.4	4.6	4.9	3.0	2.7	4.7	-42%
Southern Telecom	6.3	5.2	5.2	3.9	4.0	5.5	-27%
Uralsvyazinform	6.0	6.6	6.8	4.3	2.8	6.5	-39%
Sibirtelecom	5.2	5.5	4.1	2.8	4.0	4.8	-41%
Far East Telecom	3.4	5.4	4.1	2.4	2.8	4.3	-34%
Average	5.2	5.2	5.1	3.5	3.4	5.2	-34%

Source: Bloomberg, Gazprombank

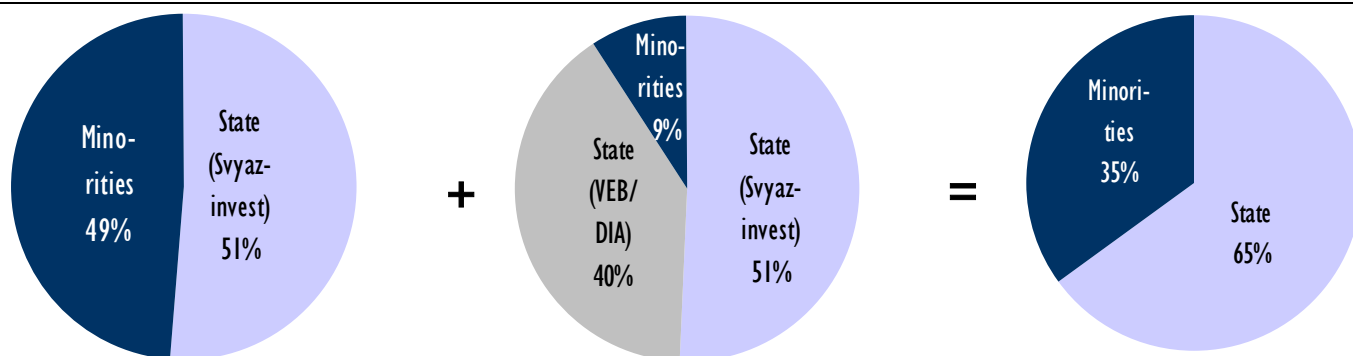
Assuming that a conservative valuation of the RTOs should lie somewhere at 4.0 EV/EBITDA and 1.3 P/BV and taking the average of two would lead us to R158bn (\$5.3bn) total value of the common stock of seven RTOs (we base our calculations on RTOs latest 1H09 IFRS financials), which is 66% above their current market capitalization.

Taking R158bn (\$5.3bn) as the total valuation of seven RTOs as our basic assumption, Rostelecom common stock should be valued at least at R97bn (\$3.2bn) so that the government could secure a 65% stake in the company after the reorganization. This translates into R133 (\$6.45) per one Rostelecom common share. On the bottom line, we regard R133 as the defensive level for Rostelecom common shares.

Regional telecoms common stock value = \$5.3bn*

Rostelecom common stock value = \$3.2bn*

Enlarged Rostelecom common stock value = \$8.5bn*



* Gazprombank estimates
Source: company data, Gazprombank

Consequently, depending on the discount rate (we use a range of 10-50%) applied to our R133 benchmark for Rostelecom common, the share price for one pref could range from R66 to R119. This suggests a 0 – 80% upside potential. The medium of the range (30% discount) gives us R93 per one preferred share or a 41% upside.

Rostelecom preferred valuation

Applied price per common share, R	Pref discount to common	Pref price, R	Upside to market price
133	-10%	119	80%
	-15%	113	71%
	-20%	106	61%
	-25%	100	52%
	-30%	93	41%
	-35%	86	30%
	-40%	80	21%
	-45%	73	11%
	-50%	66	0%

Source: Bloomberg, Gazprombank

2nd valuation approach: RTKMP benchmark - R115 per one share

Key assumption: Rostelecom common share is worth R230.

In our view, the price which was paid by the state-owned banks for a 40% stake in Rostelecom in August 2009 represents the highest valuation of the company. The price suggests a R168bn (\$5.6bn) value for Rostelecom common equity (a 17% premium to current market price) or R230 per one common share. In case seven RTOs valuation totals R158bn (see our explanation above) and Rostelecom price in the merger is R230 per share the government would secure a 71% stake in the new company while minorities would get 29% (24% would be attributable to current RTOs minorities and 5% to Rostelecom common minorities). While it is difficult to judge the probability of this price being applied during Svyazinvest reorganization in general, we believe the risk of a large discount to commons is par-

ticularly high in this scenario. The risk of RTOs common minorities objecting to the swap for Rostelecom at such a price is high (R230/share suggests a 13.8x on 2009F EV/EBITDA and a 35.4x on P/E for Rostelecom). Hence, Svyazinvest might seek to secure support from RTOs preferred minorities (prefs represent 19.5-25.0% of RTOs capital and vote in the merger) by setting particularly attractive preferred swap ratios. Even a 50% discount to R230/common would give a R115 price per one Rostelecom preferred share – more than two times as much as the current market level.

Rostelecom preferred valuation

Applied price per common share, R	Pref discount to common	Pref price, R	Upside to market price
230	-30%	161	144%
	-40%	138	109%
	-50%	115	74%
	-60%	92	40%
	-70%	69	5%

Source: Company data, Bloomberg, Gazprombank

3rd valuation approach: RTKMP benchmark - R65 per one share

Key assumption: conservative P/BV.

We would argue that an independent appraiser is unlikely to value RTOs and Rostelecom common shares below their equity book value, as this 1) would strongly unfavor Svyazinvest; 2) has no economic rationale behind it given no deterioration in RTOs and Rostelecom's asset base as well as no deflation in the economy. This said, RTOs and Rostelecom prefs valuation should not disregard the book either.

Rostelecom RAS equity book value stood at R56.7bn (appr. \$1.8bn) as of end-June. We take 1.0 P/BV as the worst-case scenario and 1.7P/BV as the best-case scenario assumptions. The latter was the multiple implied by MTS bid-price for Comstar-UTS 51% stake. Our base-case scenario suggests a simple average of the two or, 1.35 P/BV. We regard R65 per one preferred share (1.35 P/BV, a 22% discount to common) as stock defensive level. Base-case scenario suggests a 0% upside from the current RTKMP market level. Our best-case approach (1.7 P/BV and 10% discount to common) suggests R92 per share with almost 40% upside.

Rostelecom book equity value: scenario analysis

P/BV multiple	1.0	1.2	1.3	1.35	1.4	1.5	1.7
RAS book value (Rmn)	56,720*	68,063	73,735	76,571	79,407	85,079	96,423
Pref discount to common	Price per one preferred share (R)						
10%	53.9	64.7	70.1	72.8	75.5	80.8	91.6
15%	51.6	61.9	67.0	69.6	72.2	77.3	87.7
20%	49.2	59.0	63.9	66.4	68.8	73.8	83.6
25%	46.7	56.1	60.7	63.1	65.4	70.1	79.4
30%	44.2	53.0	57.4	59.6	61.9	66.3	75.1
35%	41.6	49.9	54.1	56.1	58.2	62.4	70.7
	Upside to current price						
10%	-18.3%	-1.9%	6.3%	10.4%	14.5%	22.5%	38.9%
15%	-21.7%	-6.1%	1.6%	5.6%	9.5%	17.2%	33.0%
20%	-25.4%	-10.5%	-3.1%	0.7%	4.3%	11.9%	26.8%
25%	-29.2%	-14.9%	-7.9%	-4.3%	-0.8%	6.3%	20.4%
30%	-33.0%	-19.6%	-13.0%	-9.6%	-6.1%	0.5%	13.9%
35%	-36.9%	-24.3%	-18.0%	-14.9%	-11.7%	-5.4%	7.2%

* as of June 30, 2009

Source: company data, Bloomberg, Gazprombank

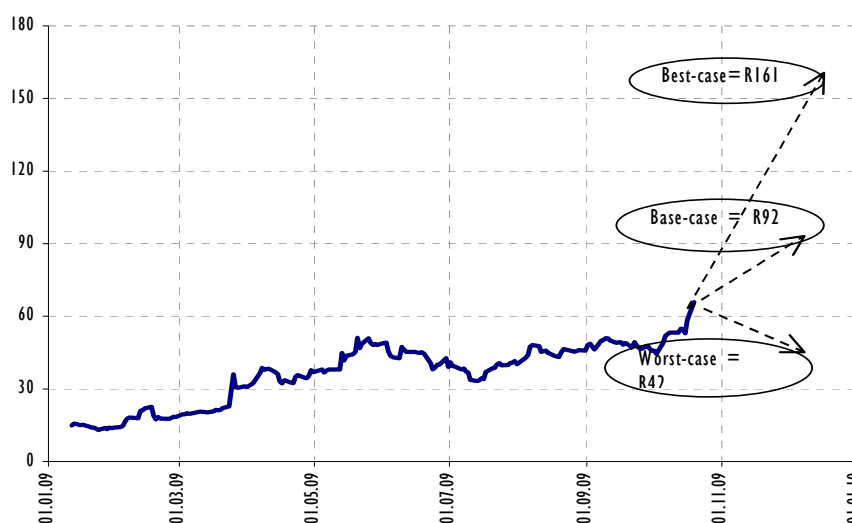
Summarizing our three scenarios we get to a R92 benchmark for Rostelecom pref (a 40% upside). Summarizing the results of three valuation approaches and applying the probability factor to different scenarios we get to R92 as our key benchmark for Rostelecom pref price during the merger. This suggests a 40% upside to the current market price. In our scenario approach we applied a 25% probability for top and bottom valuation and 50% for medium/base-case valuation.

Rostelecom preferred shares: scenario analysis summary

Valuation approach	Scenario probability	Bottom	Medium	Top
1 st valuation approach (target RTO valuation, target post-merger government's stake in Rostelecom)	50%	66	93	119
2 nd valuation approach (target RTO valuation, R230 per one Rostelecom common)	25%	69	115	161
3 rd valuation approach (P/BV approach)	25%	42	65	92
Weighted average price, R		61	92	123
Upside (Downside), %		-7%	40%	87%
Top/bottom valuation probability		25%	50%	25%
Weighted average price, R				92
Upside, %				40%

Source: Bloomberg, Gazprombank

Rostelecom preferred shares: scenario analysis summary



Source: Bloomberg, Gazprombank

Rostelecom prefs give exposure to the dividends of a new “national champion”. We believe the existing dividend policy of regional telecoms and Rostelecom would persist after the eight companies merge into one. Currently RTOs and Rostelecom pay 10% of their RAS-based full year net profit to preferred stock holders. Given the preliminary merger timetable (legal merger procedures should be completed by March 2011), the new “national champion” would pay its first dividends in 2011 based on RTOs and Rostelecom 2010 results. Assuming no significant forex losses by RTOs next year and a conservative 10% organic net income increase, we estimate total RAS net profit of the seven RTOs and Rostelecom at R38bn (\$1.3bn at current R/\$ rate) in 2010F. Hence the total dividend payout on preferred shares could reach R3.8bn (\$130mn). The amount of this dividend, attributable to current Rostelecom preferred shareholders, would depend on their share in the new Rostelecom preferred equity, i. e. preferred swap ratios. The estimated dividend per share amounts are summarized in the table below.

Our base-case scenario for common shares suggests a total RTO valuation of \$5.3bn and a Rostelecom valuation of \$3.2 (R133 per one common share). Under this scenario Rostelecom would issue 1,194mn. new common shares to pay for the seven RTOs capital, which is 2.6-fold increase from current 729 mn shares of Rostelecom. Also assuming equal pref to common discount applied for Rostelecom and RTOs shares (in our base case 30%, i. e. R93 per RTK pref) the new preferred share issue of Rostelecom should include 368mn shares (currently Rostelecom has 243mn, preferred shares). On a bottom-line, 40% of the new “champion’s” net profit could be attributable to current Rostelecom preferred holders, suggesting an estimated R6.3 dividend for 2010 and a 9% yield.



Rostelecom post-reorganization preferred share dividends (100% dividend payout = R3.8bn)

The share in new Rostelecom preferred equity, attributable to current RTK pref holders	Preferred dividend attributable to current RTK pref holders, Rmn	Dividend per one preferred share, R	Dividend yield (based on current market price)
10%	380	1.6	2.4%
20%	761	3.1	4.7%
30%	1,141	4.7	7.1%
40%	1,521	6.3	9.5%
50%	1,902	7.8	11.8%
60%	2,282	9.4	14.3%
70%	2,663	11.0	16.7%
80%	3,043	12.5	18.9%
90%	3,423	14.1	21.4%

Source: Bloomberg, Gazprombank

We observe the following key risks preventing realization of the above pref upside:

- ▶ Svyazinvest reorganization would be postponed from 2010
- ▶ Reorganization might involve a different scheme (operational holding on the basis of Rostelecom instead of asset merger). In our view, should minorities of more than one RTO disagree with swap ratios, de facto the whole merger plan would fail.

Gazprombank

HQ: 16/1 Nametkina str., Moscow 117420, Russia
(Office: 63 Novocheremushkinskaya St.)

Research Department

Andrei Bogdanov
Head of Research
+7 (495) 988 23 44

Equity/Fixed Income Strategy

Andrei Bogdanov
Artem Arkhipov
Anna Bogdyukevich
+7 (495) 988 23 44
Andrei.Bogdanov@gazprombank.ru
+7 (495) 980 41 82
Artem.Arkhipov@gazprombank.ru
+7 (495) 983 18 00 ext. 54085
Anna.Bogdyukevich@gazprombank.ru

Metals & Mining

Sergei Kanin
+7 (495) 988 24 06
Sergei.Kanin@gazprombank.ru

Transport & Car Manufacturing

Alexei Astapov
+7 (495) 428 49 33
Aleksei.Astapov@gazprombank.ru

Oil & Gas, Electric Utilities

Ivan Khromushin
Dmitry Kotlyarov
+7 (495) 980 43 89
Ivan.Khromushin@gazprombank.ru
+7 (495) 913 78 26
Dmitry.Kotlyarov@gazprombank.ru

Telecom & Media

Andrei Bogdanov
Anna Kurbatova
+7 (495) 988 23 44
Andrei.Bogdanov@gazprombank.ru
+7 (495) 913 7885
Anna.Kurbatova@gazprombank.ru

Fixed Income

Artem Arkhipov
Yakov Yakovlev
+7 (495) 980 41 82
Artem.Arkhipov@gazprombank.ru
+7 (495) 988 24 92
Yakov.Yakovlev@gazprombank.ru

Macroeconomics & Banking

Artem Arkhipov
Anna Bogdyukevich
+7 (495) 980 41 82
Artem.Arkhipov@gazprombank.ru
+7 (495) 983 18 00 ext. 54085
Anna.Bogdyukevich@gazprombank.ru

FMCG & Retail

Rustam Shikhakhmedov
+7 (495) 428 50 69
Rustam.Shikhakhmedov@gazprombank.ru

Editor/Translator

Tatiana Kumosenko
+7 (495) 983 18 00 ext. 54084
Tatiana.Kumosenko@gazprombank.ru

Debt Product Department

Pavel Isaev
Head of Debt
+7 (495) 980 4134
Pavel.Isaev@gazprombank.ru

Debt Capital Markets

Igor Eshkov
Director
+7 (495) 429 96 44
Igor.Eshkov@gazprombank.ru

Fixed Income Sales and Trading

Andrei Mironov
Head of Department
+7 (495) 428 2366
Andrei.Mironov@gazprombank.ru
Sales

Dmitry Kuznetsov
+7 (495) 428 49 80
kuzd@gazprombank.ru

Ilya Remizov
+7 (495) 983 18 80
Ilya.Remizov@gazprombank.ru

Sergey Yablonskiy
+7 (495) 719 17 74
sy@gazprombank.ru

Trading

Alexander Semennikov
+7 (495) 988 2373
Alexander.Semennikov@gazprombank.ru

Equity Product Department

Maxim Shashenkov
Head of Equity
+7 (495) 988 23 24
Maxim.Shashenkov@gazprombank.ru

Equity Sales and Trading

Sales
Konstantin Shapsharov
Director
+7 (495) 983 18 11
Konstantin.Shapsharov@gazprombank.ru

Evgeniy Tereschenko
+7 (495) 428 49 80
Evgeniy.Tereschenko@gazprombank.ru

Maria Bratchikova
+7 (495) 988 24 03
Maria.Bratchikova@gazprombank.ru

Equity Capital Markets

Andrey Chicherin
+7 (495) 983 19 14
Andrey.Chicherin@gazprombank.ru

Online Brokerage

Andrey Blokhin
+7 (495) 983 17 28
Andrey.Blokhin@gazprombank.ru

Trading

Valeriy Levit
Director
+7 (495) 988-24-11
Valeriy.Levit@gazprombank.ru

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