



### Quarterly update: Q110 results

Current price: \$8.80 (intraday)

Rating: Outperform

### June 15, 2010

Estimate changes: (new/old)

	<u>Revenue</u>	<u>EPS</u>
2010	\$436.8/\$391.5	\$1.18/ \$1.23
2011	\$550.3/ n/a	\$0.88/ n/a

### **Executive Summary:**

- **First quarter results tepid** – A-Power Energy released financial results for Q110 that were generally below our estimates. Quarterly revenue of \$67.3 million was above our \$52 million estimate, and due to two large one-time gains, EPS of \$0.64 bested our \$0.10 forecast. Backing out the two items, EPS would have been \$0.03. Gross margins of 14.5% continued to remain healthy and essentially in-line with our expectations of 14.9%. Operating expenses expanded to a record high of \$8.9 million or 13.2% of total revenue for the quarter. The recent Evatech acquisition accounted for approximately \$2.8 million of the jump, but the remaining \$6.1 million was a surprisingly 9.1% of revenue, more than double 2009’s results. The higher operating expenses negatively impacted EBITDA results of \$2.3 million (absent the \$13.6 million Evatech gain) vs. our \$6.1 million estimate. Guidance for 2010 was increased, yet we remain cautious given the generally tepid first quarter results.
- **2010 guidance improves** – Company guidance changed materially, once again, from last quarter. Recently, on March 31<sup>st</sup>, 2010, management issued “new” guidance for 2010 of \$380 million in revenue and net income of \$45 million. The forecast was materially below our and the street’s estimates for 2010, yet we surmised a potential inflection point in the over-promising/under-delivering mantra emanating from the company. With rationalized guidance, we believed credibility could improve, consensus could be attained, risk could be reduced and a valuation multiple more in-line with potential reward would be the likely outcome. Our suppositions were short-lived as guidance for 2010 has been ramped back up to \$500 million top-line and \$60 million in net income. We are now firmly below company guidance as our forecast for 2010 improves slightly to \$436.8 million from \$391.5 million in revenue and net income of \$54.7 million vs. \$56 million previously.

### **Conclusion:**

Investing in shares of A-Power poses large risks to investors, yet we believe the current valuation offers an opportunity to gain exposure at a fair market price. AERCA has fully transitioned, due to increasing non-cash charges, to evaluating shares of APWR on an EV/EBITDA ratio. Currently valued at 6.4 times our 2011 EBITDA estimate of \$53 million on an EV basis, we believe shares of APWR are fairly valued at 9 to 10 times and are reiterating our Outperform rating (see disclosures).

## Estimate Summary:

In millions (except per share data)

	Revenue		Net Income		EPS	EBITDA
2007A	\$	152,544	\$	15,214	\$ 2.23	\$ 17,286
2008A	\$	264,865	\$	28,515	\$ 1.01	\$ 29,793
Q1A		31,199		1,565	0.05	2,036
Q2A		57,518		6,252	0.14	7,133
Q3A		96,647		(623)	(0.02)	487
Q4A		125,888		(23,885)	(0.68)	(20,956)
2009A	\$	311,252	\$	(16,691)	(0.48)	(11,300)
Q1A		67,337		29,301	0.64	15,926
Q2E		87,000		3,813	0.08	5,778
Q3E		125,000		8,775	0.19	10,920
Q4E		157,500		12,788	0.27	15,266
2010E	\$	436,837	\$	54,677	\$ 1.18	\$ 47,890
Q1E	\$	107,750	\$	8,120	\$ 0.17	\$ 10,700
Q2E		122,500		9,300	0.20	11,990
Q3E		144,000		11,020	0.23	13,820
Q4E		176,000		13,580	0.28	16,490
2011E	\$	550,250	\$	42,020	\$ 0.88	\$ 53,000

*Source: Company and AERCA estimates*

## Valuation:

	P/S	P/E	EV/EBITDA
2007A	2.7	4.0	19.6
2008A	1.5	8.7	11.3
2009A	1.3	-18.4	-29.9
2010E	0.9	7.5	7.1
2011E	0.7	10.0	6.4

## Recent Results:

A-Power's financial results for the first quarter of 2010 were released on June 10<sup>th</sup>, 2010. Revenue of \$67.3 million bested our estimate of \$52 million with EPS of \$0.64 vs. our \$0.10 forecast. One-time gains improved the bottom line results tremendously with a \$14.2 million warrant adjustment and a \$13.6 million gain on the Evatech acquisition. Backing out the gains, EPS for the quarter were \$0.03 compared to our estimate of \$0.10. Although gross margins of 14.5% were slightly below our 14.9% estimate, the primary culprit for the adjusted underperformance was the operating expense line. As stated previously, operating expenses rose to 9.1% of revenue when adjusting for the Evatech expense portion. This figure is the highest in company history and is more than double 2009's 4.1%. Operating margin moved to 1.3%, and although some one-time expenses were included in the quarter, we believe the ultra-lean operating expense A-Power has enjoyed during much of its early history is now part of its history and not the future. When adding the Evatech expenses, along with increased expenses associated with the continuing wind turbine ramp, our operating margin forecast is substantially reduced to 6.4% from 14.3% in 2010.

EBITDA for the quarter was a paltry \$2.3 million when removing the Evatech gain vs. our \$6.1 million estimate due to the large jump in operating expenses and as we are now assuming higher operating expenses on an ongoing basis, EBITDA estimates for 2010 are lower as a result.

A-Power management attempted to further delineate the large Texas wind project. The company now anticipates commencement of construction of the new wind turbine facility by the end of this year. Financing and other related developments are also expected to be ready by year-end with initial sales arriving late in 2011 or 2012. Although we remained concerned about the political ramifications and potential funding delays related to the utilization of large ARRA stimulus funds to fill the funding gap, we are now modeling modest revenue and margin contribution from the project in late 2011.

## Outlook:

A-Power management guidance for 2010 was increased from \$380 million in revenue to \$500 million with GAAP net income of \$60 million (previous net income guidance of \$45 million was non-GAAP). The substantial change in the outlook for revenue and net income, albeit pointing in the positive direction, does not necessarily improve our view of the company. Many missteps in terms of guidance vs. actual results had taken place over the first few years since A-Power became a publicly traded entity. In our opinion the company deserved some latitude at the onset, but now, with over two years of experience and a full management team in place, the benefit of the doubt is no longer applicable in our view.

We believed per the last guidance issued on March 31, 2010 that A-Power was rationalizing its outlook and correctly managing expectations. We also believed that despite lowered expectations and potentially lower actual reported results, the market's perception of risk could be reduced and result in a potentially expanded valuation multiple. We do not view the recent guidance as representative of this potentially favorable dynamic.

Despite the increase of \$120 million in revenue guidance, a 31.5% improvement over the guidance issued in March, we remain cautious. We are forecasting revenue for 2010 of \$436.8 million vs. \$391.5 million, an 11.6% increase. Revenue from 100 wind turbine sales, plus a ramp in DG contract bookings enables us to arrive at our new estimate, however we believe \$500 million is an aggressive target and we will remain below company forecasts.

Gross margin forecasts remain unchanged at 18%, but as discussed previously, operating margins have been dramatically reduced due to operating expense assumptions on a forward basis. Our new operating margin estimate for 2010 is 6.4% vs. 14.3%. Management expects margins to improve slightly as the first quarter contained some one-time consulting expenses, but it is our belief that A-Power's ability to keep operating expenses on par with the extraordinarily low levels of the past is no longer valid.

Net income is also negatively impacted by the increase in operating expense assumptions. Company guidance, on a GAAP basis, which includes the one-time Evatech gain, is now \$60 million for net income. Our forecast moves to \$54.7 million from \$56.0 million. Including the Evatech gain but excluding the warrant adjustment gain in Q1 would reduce our net income estimate to \$40.5 million. The various accounting gymnastics, exclusions and inclusions, and one-time gains provide further support for our move to value shares of A-Power on an EBITDA basis, yet as discussed next, even EBITDA has its flaws.

The substantial reduction in operating margins moves our EBITDA forecast lower for 2010. Although the Evatech gain remains inside the EBITDA annual forecast, the one-time gain could be fairly argued for removal resulting in an even more dramatic reduction. Given the benefit of the gain, our EBITDA estimate for 2010 is reduced to \$47.9 million from \$65.2 million. EPS are similarly reduced to \$1.18 from \$1.23. As our outlook on the company becomes more focused on EBITDA, we may opt to move to an adjusted EBITDA estimate for valuation purposes as the inclusion of the Evatech gain is a material adjustment.

Our initial 2011 forecast is based on the existing DG backlog, some assumed contract wins and a continued ramp in the wind turbine business, especially the large Texas project. Our confidence and visibility into 2011 is lower than we prefer and our estimates and forecasts are subject to large revisions. We are projecting \$550.3 million in revenue, gross margin improvement of 1% Y/Y to 19%, a rebound in operating margin to 8% from 2010's depressed 6.4%, and net income of \$42 million. Our initial EPS forecast is \$0.88 with EBITDA of \$53.0 million.

## Valuation:

Increased confidence in solid future operational and financial performance emanating from A-Power's fourth quarter 2009 results, which displayed encouraging signs of margin expansion and a return to large organic growth potential, has dissipated. In addition, our confidence in management's ability to navigate the expectations for a publicly traded entity has also been reduced as revenue guidance is increased 31% in one quarter. We believe the competitive positioning and potential growth for A-Power remains, but as confidence gets reduced, risk increases, eliminating any potential multiple expansion.

Our view that shares of APWR provide investors with a speculative investment opportunity to gain exposure to the company's robust end-markets remains unchanged. Despite our reduced EBITDA forecast, we believe a 9 to 10 multiple fairly reflects the company's strong growth prospects with the speculative nature of investing in APWR. In our opinion shares should outperform our benchmark index (see disclosures) over the next 12 months and we reiterate our rating of **Outperform**.

## Risks:

**Foreign Private Issuer** – A-Power has stated that the company is a foreign private issuer within the meaning of the SEC.

*Due to its foreign private issuer status, the company will NOT be required to file with the SEC 10-Q nor 8-K reports. The company will be exempt from Reg FD provisions and sections of the Securities Exchange Act requiring solicitation of proxies, consents or authorizations related to registered securities, and finally exemption to the filing of public reports by insiders with respect to their ownership and trading activities.*

Clearly, exemption from required financial information and reporting, when combined with the exemptions for Reg FD and insider reporting, is the largest risk for investors.

A-Power, for its part, continues to address the financial reporting exemption. A-power issues regular quarterly financial reports and information and conducts quarterly conference calls with interested investors. The company anticipates filing quarterly financial reports on time and "according to SEC filing requirements", but has, in some instances, released limited financial data and information later than the usual required filing date.

Concerns regarding Reg FD and insider trading activities will pose continuing risks to investors as the company is not required to meet usual SEC and traditional Western investor standards. The company will endeavor to disclose information in a fair and timely manner to all investors equally, yet no assurances can be given as to the symmetrical dissemination of material information to all global investors.

**Financial Control** – The company stated that as a privately held company, GaoKe historically did not focus on Western style financial reporting and internal control systems. A lack of management, legal and financial controls that meet Western standards may be difficult to achieve as A-Power focuses on near-term growth opportunities. We view the relative opaqueness into GaoKe's operations as another large risk for investors seeking information about the company and its financial progress.

**Reliance on Top-Level Management** – A-Power relies heavily on the services of its engineering talent, especially the talent and expertise of Mr. Jinxiang Lu. A suitable replacement for Mr. Lu would be extremely difficult to find and the company would likely be severely impaired if Mr. Lu no longer was available to lead the company. Mr. Lu also owns a majority of the company, further highlighting his importance and ability to direct the fortunes of the company at the possible expense of minority shareholders.

**Chinese Regulations and Incentives** – A-Power’s primary market, the PRC, could alter, change or eliminate various regulations and rules regarding the development of power, distributed or grid related, that could materially alter the competitive position of the company. PRC tariff policy, economic reform packages, foreign currency regulations and other policies beyond the control of A-Power could materially affect the company’s prospects substantially, especially incentive policies relating to the emerging wind power market in China. Substantial changes could cause our outlook to be changed dramatically.

**British Virgin Islands Incorporation** – A-Power is incorporated in the British Virgin Islands and does not afford investors the same legal protections for minority shareholders. Various fiduciary and liability rights properly established and enforced in the U.S. may not be available to holders of A-Power, resulting in a diminished degree of protection from management wrongdoing or other actions.

## A-Power Energy Generation and Subsidiaries - Income Statement

(in 000s except per share data)

	2006A*	2007A*	2008A	2009A	1Q10A	2Q10E	3Q10E	4Q10E	2010E	1Q11E	2Q11E	3Q11E	4Q11E	2011E
Net Revenues	\$ 98,705	\$ 152,544	\$ 264,865	\$ 311,252	\$ 67,337	\$ 87,000	\$ 125,000	\$ 157,500	\$ 436,837	\$ 107,750	\$ 122,500	\$ 144,000	\$ 176,000	\$ 550,250
Cost of Revenues	(85,915)	(131,987)	(227,988)	(260,167)	(57,566)	(72,384)	(101,375)	(126,788)	(358,113)	(87,278)	(99,225)	(116,640)	(142,560)	(445,703)
<b>Gross Profit</b>	<b>12,790</b>	<b>20,557</b>	<b>36,877</b>	<b>51,085</b>	<b>9,771</b>	<b>14,616</b>	<b>23,625</b>	<b>30,713</b>	<b>78,725</b>	<b>20,473</b>	<b>23,275</b>	<b>27,360</b>	<b>33,440</b>	<b>104,548</b>
Operating expenses														
Selling expenses	-	-	-	-	-	-	-	-	-	-	-	-	-	-
General and administrative	(1,900)	(3,482)	(8,700)	(12,844)	(8,916)	(10,353)	(14,375)	(17,325)	(50,969)	(11,853)	(13,475)	(15,840)	(19,360)	(60,528)
Research and development	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total operating expenses	(1,900)	(3,482)	(8,700)	(12,844)	(8,916)	(10,353)	(14,375)	(17,325)	(50,969)	(11,853)	(13,475)	(15,840)	(19,360)	(60,528)
<b>Operating income</b>	<b>10,890</b>	<b>17,075</b>	<b>28,177</b>	<b>38,241</b>	<b>855</b>	<b>4,263</b>	<b>9,250</b>	<b>13,388</b>	<b>27,756</b>	<b>8,620</b>	<b>9,800</b>	<b>11,520</b>	<b>14,080</b>	44,020
Interest income (expense)	(237)	(1,882)	13	(369)	-	(50)	(75)	(100)	(225)	(100)	(100)	(100)	(100)	(400)
Financing expense	-	-	(134)	(272)	(746)	(500)	(500)	(600)	(2,346)	(500)	(500)	(500)	(500)	(2,000)
Interest income	72	-	8	-	-	-	-	-	-	-	-	-	-	-
Other income (expenses)	-	250	924	437	1,510	100	100	100	1,810	100	100	100	100	400
Accretion on convertible debt	-	-	-	(2,280)	-	-	-	-	-	-	-	-	-	-
Change in fair value - warrants	-	-	-	(11,596)	14,200	-	-	-	14,200	-	-	-	-	-
Change in fair value - embedded derivative	-	-	-	(25,611)	-	-	-	-	-	-	-	-	-	-
Gain on investment-Evatech	-	-	-	-	13,589	-	-	-	13,589	-	-	-	-	-
Make-whole amount paid on conversion	-	-	-	(9,886)	-	-	-	-	-	-	-	-	-	-
Fair value of inducement	-	-	-	(3,394)	-	-	-	-	-	-	-	-	-	-
Income from continuing operations before income taxes	10,725	15,443	28,988	(14,730)	29,408	3,813	8,775	12,788	54,784	8,120	9,300	11,020	13,580	42,020
Income tax expenses	(3,218)	(190)	(71)	(1,792)	(226)	-	-	-	(226)	-	-	-	-	-
Minority Interest	3	(39)	(402)	(169)	119	-	-	-	119	-	-	-	-	-
<b>Net income</b>	<b>7,507</b>	<b>15,214</b>	<b>28,515</b>	<b>(16,691)</b>	<b>29,301</b>	<b>3,813</b>	<b>8,775</b>	<b>12,788</b>	<b>54,677</b>	<b>8,120</b>	<b>9,300</b>	<b>11,020</b>	<b>13,580</b>	<b>42,020</b>
Foreign currency adjustment	-	-	4,767	(119)	(2,241)	-	-	-	(2,241)	-	-	-	-	-
<b>Comprehensive income</b>	<b>7,507</b>	<b>15,214</b>	<b>33,282</b>	<b>(16,810)</b>	<b>27,060</b>	<b>3,813</b>	<b>8,775</b>	<b>12,788</b>	<b>52,436</b>	<b>8,120</b>	<b>9,300</b>	<b>11,020</b>	<b>13,580</b>	<b>42,020</b>
Basic	\$ 37.54	\$ 2.33	\$ 1.02	\$ (0.49)	\$ 0.66	\$ 0.09	\$ 0.19	\$ 0.28	\$ 1.23	\$ 0.18	\$ 0.21	\$ 0.23	\$ 0.29	\$ 0.91
Diluted	\$ 37.54	\$ 2.23	\$ 1.01	\$ (0.48)	\$ 0.64	\$ 0.08	\$ 0.19	\$ 0.27	\$ 1.18	\$ 0.17	\$ 0.20	\$ 0.23	\$ 0.28	\$ 0.88
Weighted average number of shares out														
Basic	200	6,530	27,995	34,199	44,080	44,080	45,080	45,080	44,580	45,080	45,080	47,080	47,080	46,080
Diluted	200	6,834	28,248	34,967	45,704	45,704	46,925	46,925	46,315	46,925	46,925	48,925	48,925	47,925
<b>Gross Margin</b>	13.0%	13.5%	13.9%	16.4%	14.5%	16.8%	18.9%	19.5%	18.0%	19.0%	19.0%	19.0%	19.0%	19.0%
<b>SG&amp;A/Sales</b>	1.9%	2.3%	3.3%	4.1%	13.2%	11.9%	11.5%	11.0%	11.7%	11.0%	11.0%	11.0%	11.0%	11.0%
<b>Operating Margin</b>	11.0%	11.2%	10.6%	12.3%	1.3%	4.9%	7.4%	8.5%	6.4%	8.0%	8.0%	8.0%	8.0%	8.0%
<b>Net Income/sales</b>	7.6%	10.0%	10.8%	-5.4%	40.2%	4.4%	7.0%	8.1%	12.0%	7.5%	7.6%	7.7%	7.7%	7.6%
<b>Year over Year Growth</b>														
<b>Sales</b>	N/A	55%	74%	18%	116%	51%	29%	25%	40%	60%	41%	15%	12%	26%

\* Based on Head Dragon and subs.

Source: Company and AERCA estimates

## A-Power Energy Generation and Subsidiaries - Balance Sheet

(in 000's except per share data)

	12/31/2007	12/31/2008	12/31/2009	3/31/2010
<b>Assets</b>				
<b>Current Assets</b>				
Cash and cash equivalents	\$ 35,832	\$ 43,518	\$ 166,476	\$ 157,639
Restricted bank balance	-	3,608	13,399	62,740
Accounts receivable, net	20,980	8,036	12,463	15,145
Costs and estimated earnings in excess of billings on uncompleted contracts	-	-	2,967	2,986
Prepayments, deposits and other receivables	3,119	79,845	52,452	102,367
Inventory	-	8,722	10,327	23,940
Due from related parties	32	105	105	106
<b>Total current assets</b>	<b>59,963</b>	<b>143,834</b>	<b>258,189</b>	<b>364,923</b>
Accounts receivable	1,843	3,646	5,738	5,603
Construction in progress	411	18,006	-	-
Property, plant and equipment, net	2,502	14,312	58,617	71,929
Intangible assets	-	12,564	22,412	43,166
Deposits on intangible assets	3,729	10,322	5,657	1,407
Deferred income tax asset	-	364	2,321	4,387
Deferred financing costs	-	-	-	-
Long-term investment	-	-	2,423	40,629
Long-term prepayment and other assets	-	-	-	36
<b>Total Assets</b>	<b>\$ 68,448</b>	<b>\$ 203,048</b>	<b>\$ 355,357</b>	<b>\$ 532,080</b>
<b>Liabilities and Stockholder's Equity</b>				
<b>Current Liabilities</b>				
Bank loans	\$ 960	\$ -	\$ 20,368	\$ -
Accounts payable	18,047	30,136	15,415	16,802
Other payable and accrued liabilities	-	-	24,619	31,772
Customer deposits	2,480	16,076	9,993	12,036
Billings in excess of costs and estimated earnings on uncompleted projects	-	-	4,887	3,961
Due to shareholder	376	-	-	-
Due to related party	-	128	4,158	18,943
Income and business taxes payable	51	741	4,078	5,634
Unearned revenue	-	-	1,419	2
Deferred income tax liability	-	-	31	3,847
Notes payable	15,000	-	-	-
Short-term loans	-	-	-	69,090
<b>Total current liabilities</b>	<b>36,914</b>	<b>47,081</b>	<b>84,968</b>	<b>162,087</b>
Warrant liability	-	-	17,750	28,051
Fair value of embedded derivatives-convertible note	-	-	-	1,428
Convertible note	-	-	-	-
Minority interest	256	658	-	-
Retirement benefit obligation	-	-	-	915
<b>Total liabilities</b>	<b>37,170</b>	<b>47,739</b>	<b>102,718</b>	<b>192,481</b>
<b>Shareholders' Equity</b>				
Common stock	1,667	3	4	5
Preferred shares	54	-	-	-
Additional paid-in-capital	1,671	94,137	203,491	257,943
Accumulated other comprehensive income	2,016	6,783	6,459	4,217
Statutory reserves	3,307	3,307	4,155	4,197
Retained earnings	22,563	51,079	(1,651)	27,608
Noncontrolling interest	-	-	40,180	45,629
<b>Total shareholders' equity</b>	<b>31,278</b>	<b>155,309</b>	<b>252,638</b>	<b>339,599</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 68,448</b>	<b>\$ 203,048</b>	<b>\$ 355,356</b>	<b>\$ 532,080</b>
Book value/share	\$ 3.66	\$ 4.63	\$ 7.22	\$ 7.43
Net Cash/share	\$ 4.19	\$ 1.30	\$ 4.75	\$ 3.45
Debt/Capital	34%	0%	9%	21%

Source: Company and AERCA estimates

## Stock Data:

### 3 year stock chart:



Source: Bigcharts.com

### Companies mentioned in this report:

- None

### Data Table:

Average volume (mill. shares)	1.39
52 week range	\$6.56 - \$21.04
Short interest (mill. shares)	6.10
Shares outstanding (mill. shares)	46.3
Market Capitalization (\$ millions)	407.6
Enterprise value (\$ millions)	338.0

## Analyst Disclosures:

I, Brian C. Yerger, the author of this research report, certify that the views expressed in this report accurately reflect my personal views about the subject securities and issuers, and no part of my compensation was, is or will be directly or indirectly tied to the specific recommendations or views contained in this research report.

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## Ratings Definitions:

**Outperform:** Our Outperform rating is based on our belief that the subject company is anticipated to produce a total return greater than our benchmark index, The Wilderhill Clean Energy Index (ECO), over the coming 12 months.

**Marketperform:** Our Marketperform rating is based on our belief that the subject company is anticipated to produce a return equal to our benchmark index, The Wilderhill Clean Energy Index (ECO), over the coming 12 months.

**Underperform:** Our Underperform rating is based on our belief that the subject company is anticipated to produce a return less than our benchmark index, The Wilderhill Clean Energy Index (ECO), over the coming 12 months.

**Additional Disclosures**

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