



Equity Research

November 27, 2007

Q4 2007 HME Sleep & Wound Care Survey

Sector Rating: Orthopedics, Overweight

Sector Rating: Respiratory, Overweight

Company Name	Stock Rating	Price 11/27/07	FY EPS		FY P/E	
			2007E	2008E	2007	2008
Orthopedics						
Kinetic Concepts, Inc. (KCI)	2	\$59.24	\$3.29	\$3.85	18.0x	15.4x
Respiratory						
ResMed Inc. (RMD)	1	45.07	1.43 A	1.60	31.5x	28.2x
Respironics, Inc. (RESP)	1	49.13	1.65 A	1.96	29.8x	25.1x

Source: Company data and WCM, LLC estimates NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful
1 = Outperform, 2 = Market Perform, 3 = Underperform, V = Volatile

- **Our Third HME Survey.** We partnered with *Home Health Products* magazine to conduct our third survey of home medical equipment dealers (HMEs). The survey included responses from 100 HMEs received between 11/2/07 and 11/13/07.
- **Sleep Growth On Par With Prior Surveys.** On average, respondents expect their sleep revenue to grow by 11% (vs. 13% in our prior survey) in the next 12 months after growing at 10% in the past 12 months (vs. 12% in our prior survey). This is comparable to our estimate of 14% growth in the U.S. sleep market year-to-date.
- **CPAP Pricing Stable But Competitive Bidding May Drive Reimbursement Down.** Respondents' average price for a flow generator declined by 2.1% in the past 12 months. Respondents' average price for a mask declined by 0.1% in the past 12 months. We believe that these are less severe than the price declines cited by manufacturers (5-15%) due to a mix shift to higher end products. The majority of respondents (68%) expect to participate in Medicare's competitive bidding program. On average, respondents expect CPAP reimbursement to decline by 15% under competitive bidding.
- **RESP Flow Generators, RMD Masks Rate Highest.** RESP's M Series was rated 5.6 on a scale from 1 (very poor) to 7 (very good) while RMD's S8 was rated 5.0. This was a step down for the S8 which had rated 5.7 in our prior survey; we suspect RMD's recall may have slightly tarnished the S8's reputation. RMD's Swift II was rated 5.4 while RESP's OptiLife was rated 4.7. RESP looks likely to gain flow generator share (54% expect to increase RESP purchases, 13% to decrease) while both RESP (49% expect to increase, 9% to decrease) and RMD (47% expect to increase, 14% to decrease) look likely to gain mask share.
- **Only A Minority Offer Negative Pressure Wound Therapy (NPWT) But More Plan To Start.** Only 15% of respondents currently offer NPWT products though another 13% expect to enter the market in the next 6 months. Nearly all respondents offering NPWT target the home market (93%) while 50% target the extended care market and 43% target the acute care market. HMEs charge an average of \$63/day for NPWT, which we think is well below levels charged by KCI.
- **Reiterate Outperform Ratings On RESP and RMD.** We believe that sleep market fundamentals remain strong with good underlying growth and reasonably stable ASPs (with negative pricing offset by positive mix).

Medical Technology/Devices

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Please see page 10 for rating definitions, important disclosures and required analyst certifications.

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Survey Highlights

We think that the survey supports our bullish views on the sleep market and Respironics (RESP) and ResMed (RMD) and our cautious view on Kinetic Concepts (KCI). The sleep therapy market appears to continue to have solid growth with underlying patient growth in the low- to mid-teens which drives low- to mid-teens flow generator growth and high-teens mask growth (outpacing flow generator growth due to increased mask utilization among the existing base of CPAP users). While prices on both masks and flow generators continue to decline, an ongoing mix shift to higher end products seems to offset price declines. Respironics appears likely to continue to gain market share (primarily from Puritan Bennett but also from Fisher & Paykel) while ResMed appears likely to see its market share stabilize. Share losses at Covidien's (COV) Puritan Bennett division (which we estimate is 6-8% of the market) appear likely to accelerate sharply over the next year; this is not surprising in our view given an aging product line-up and Covidien's relocation of Puritan Bennett to Colorado which, according to our checks, has resulted in turnover and significant delays in new product launches.

While the negative pressure wound therapy (NPWT) market remains attractive as well, we remain concerned that KCI is vulnerable to competitive pressures. Only a minority of the HMEs we surveyed currently offers NPWT but the number of HMEs offering NPWT should almost double over the next 12 months. As oxygen reimbursement continues to get squeezed we believe HMEs are seeking products with faster growth and more lucrative reimbursement such as sleep and NPWT products. Additionally, we think that the increase in manufacturers selling NPWT systems (we are aware of six in the U.S. that are selling or preparing to sell NPWT systems) may be increasing awareness and interest among HMEs. And although HMEs typically focus on the home setting, our survey indicates that many HMEs selling NPWT are also targeting the acute and extended care settings. While KCI does not break out the portion of its revenue that it derives from each care setting, we think that the majority is from the acute care setting although growth is likely higher in the home setting. KCI bulls often cite the high levels of payment rejections from Medicare for NPWT though this is just for the home portion of the market. We suspect that HMEs have an easier time collecting payments for NPWT from acute and extended care facilities since these are typically not paid directly by insurers but rather out of the facilities' operating budgets.

We expect the increased NPWT competition to manifest itself primarily in the form of pricing pressure; we have heard that KCI charges as much as \$100 per day for its NPWT pumps while our survey indicates that HMEs intend to charge an average of around \$63 per day. Our analysis shows that for every 1% decline in NPWT pricing, KCI's gross margin declines by about 40-50 bps and EPS declines by \$0.06-0.07. We acknowledge that KCI's NPWT pumps are much more sophisticated (with color touch screens, etc) than competitors and believe that ease of use benefits may allow KCI to sustain a pricing premium but still see risk that prices to come under pressure. The key question, in our view, is who drives the selection of an NPWT system. If the selection is truly physician driven and physicians prefer KCI's VAC system, we think KCI will be largely unaffected by competition. However, if the selection is made by cost-focused purchasing managers or wound care nurses (who are typically employed by the facilities and probably have less ability to resist management directives than physicians) we think that price sensitivity may be significant. While all three likely influence the decision, our thesis is that the purchasing managers and nurses are a bigger factor than physicians. We intend to do additional survey work to get a better grasp of the purchasing decision for NPWT and to test this thesis; the outcome of this work would have the potential to sway our view of KCI in either direction.

Survey Background

Wachovia partnered with the trade magazine *Home Health Products* to conduct our third survey of home medical equipment (HME) providers. Among the ~4,000 HME professionals that we sent the survey to, 100 responded to one or more of the survey questions for a total participation rate of 2-3%. None of the questions in this survey were mandatory, therefore response rates varied from question to question (we note the response rates for each question in the lower left corner of the charts). The surveys replies were received between 11/2/07 and 11/13/07.

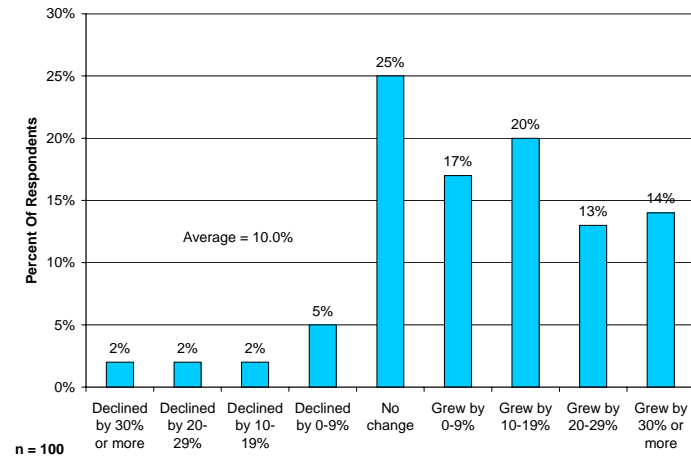
Survey Says...

Sleep Therapy Questions

...HME Sleep Revenue Growth Remains Solid And Consistent With Our Earlier Surveys

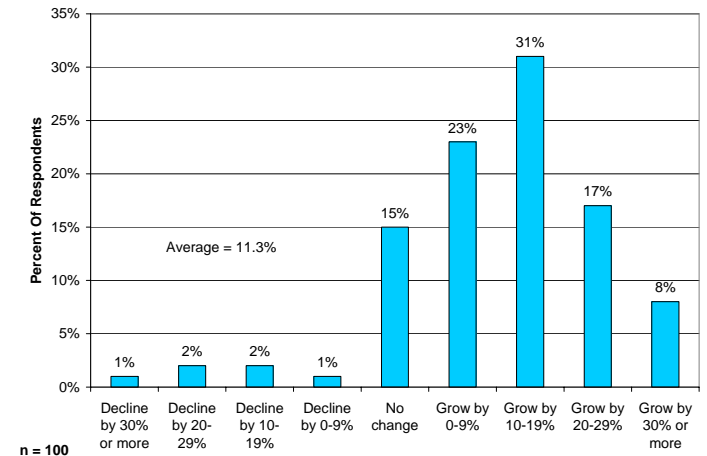
HMEs are bullish about growth prospects for their sleep businesses. On average, HMEs report 10.0% growth in the past 12 months and expect 11.3% growth in the next 12 months. Only 11% saw a decline in their sleep revenue in the past 12 months and only 6% expect a decline in the next 12 months. These growth rates compare with our estimate of 14% domestic growth and results from our last two surveys.

Figure 1: Sleep Revenue Growth Past 12 Months



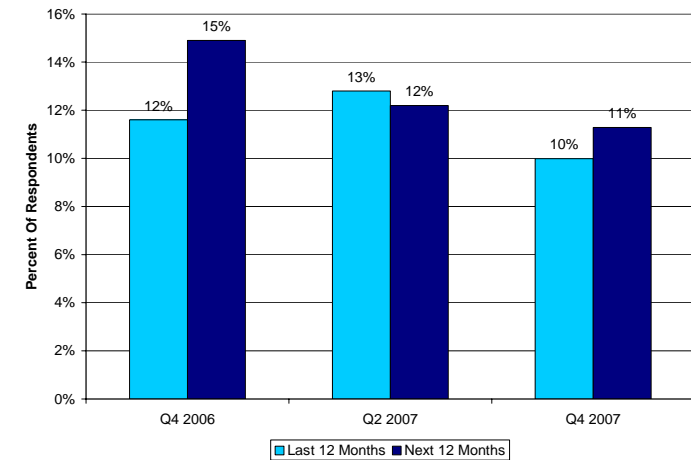
Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

Figure 2: Sleep Revenue Growth Next 12 Months



Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

Figure 3: Sleep Revenue Growth (Time Series)



Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

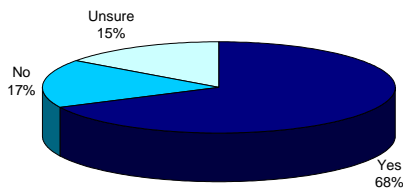
...Most HMEs Plan To Participate In Competitive Bidding For Sleep Therapy Products Despite Expectations Of A Sharp Decline In Reimbursement Under Bidding

About 2/3 of HMEs (68%) expect to participate in Medicare’s competitive bidding for sleep therapy products when it is implemented in their metro areas. Despite their willing participation, most HMEs do expect a substantial decline in reimbursement—on average HMEs see reimbursement declining by 14.9% under bidding. This estimate is consistent with other experts we have spoken with including HME consultant Jeff Baird (see our 9/10/07 note titled *DME Competitive Bidding Call Highlights*).

...Prices Paid By HMEs For Flow Generators And Masks Have Been Relatively Stable

HMEs report that the average prices that they pay for flow generators and masks have been relatively stable, declining by averages of just 2.1% and 0.1%, respectively, over the past 12 months. The manufacturers cite 5-15% annual price declines, however. How do we explain this differential? We think that the manufacturers refer to pure pricing while the HMEs refer to average selling prices (ASPs) which account for the effect of mix shifts as well as pricing. This seems to support our thesis that there is a significant positive mix shift towards higher end products that largely offsets pricing declines.

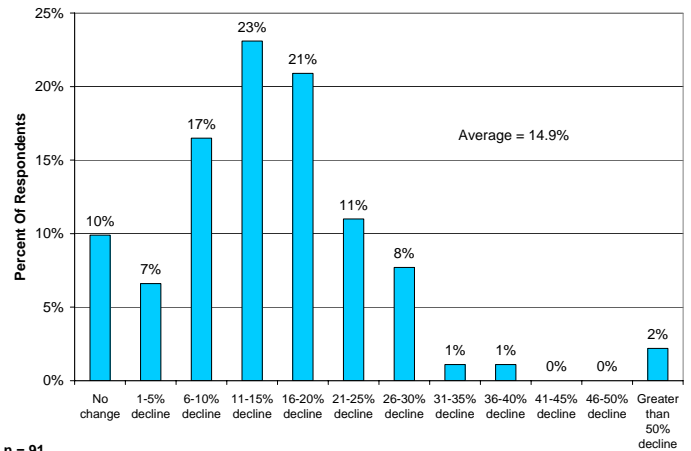
Figure 4: Do You Intend To Participate In Medicare’s Competitive Bidding Program For CPAP Products?



n = 93

Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

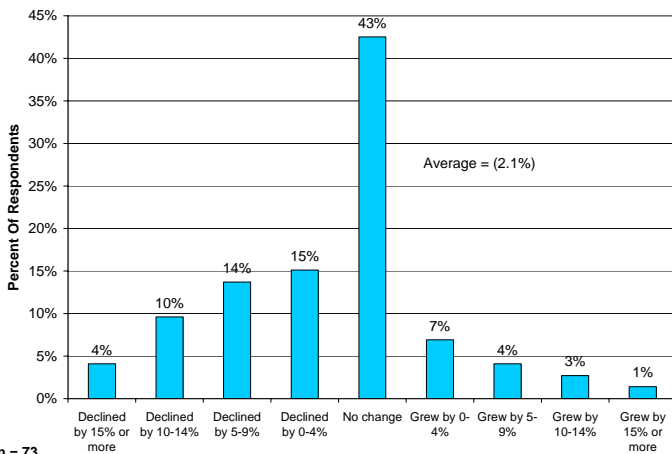
Figure 5: How Much Do You Expect CPAP Reimbursement To Decline Under Competitive Bidding?



n = 91

Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

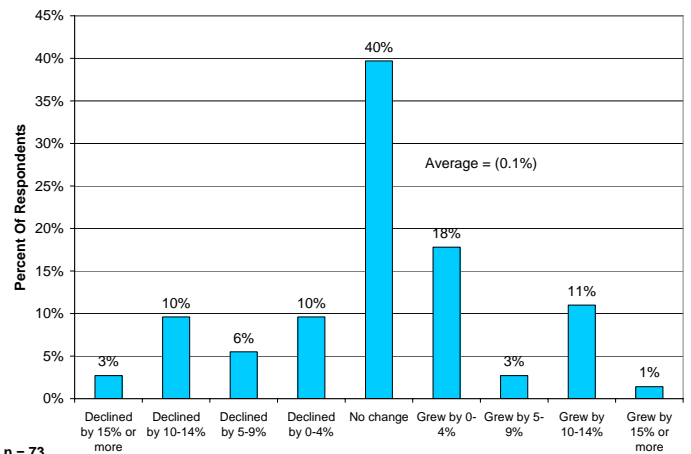
Figure 6: By What % Has The Average Price You Pay For A Flow Generator Changed In Past 12 Months?



n = 73

Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

Figure 7: By What % Has The Average Price You Pay For A Mask Changed In Past 12 Months?



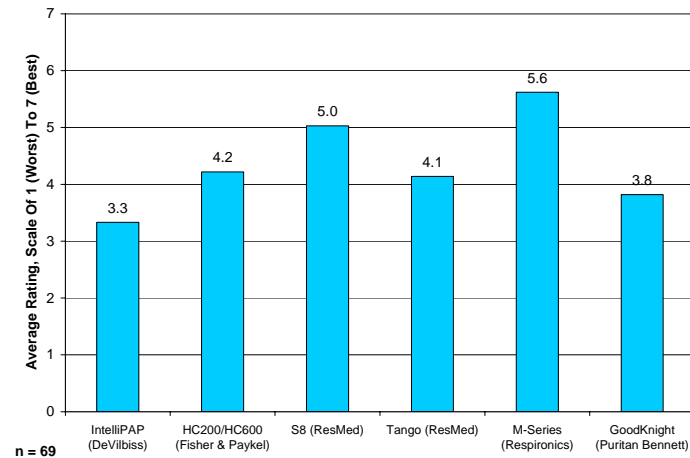
n = 73

Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

...Respironics' Flow Generators Were Rated Highest And Respironics Looks Likely To Continue To Gain Flow Generator Market Share

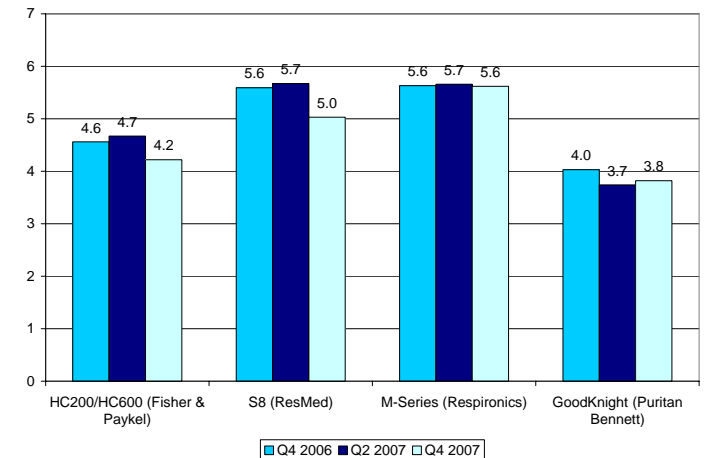
One of the most surprising results on our survey was the decline in ratings for ResMed's S8 flow generator platform which fell from 5.6 and 5.7 (out of 7.0) in our prior two surveys to 5.0 in this survey. While not a huge decline, it does seem to indicate that HMEs have begun to favor Respironics' M Series platform. This is consistent with our last Q3 2007 Sleep Center Survey in which the M Series was rated just ahead of the S8 as well (5.8 vs. 5.5). We suspect (though we lack evidence) that ResMed's recall of the S8 may have slightly tarnished its reputation. This is also the first time we have asked the HMEs to rate ResMed's new Tango flow generator; based on its 4.1 rating, we think it is clear why it has struggled against the low-end M Series product. However, ResMed has begun targeting Fisher & Paykel's flow generators and we think it may have some success against these products given similar product designs and ratings.

Figure 8: Flow Generator Platform Ratings



Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

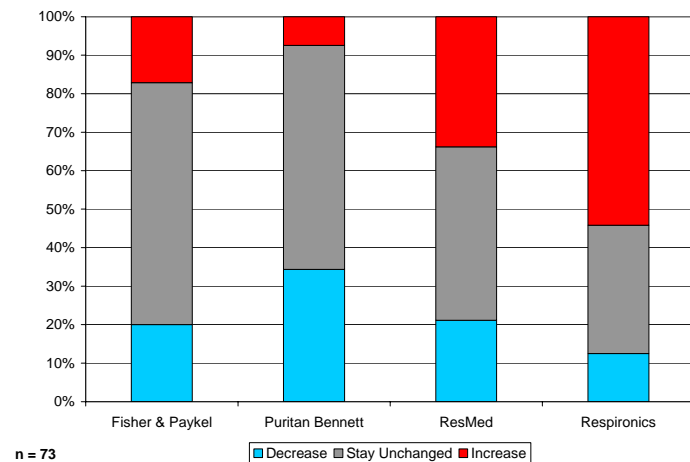
Figure 9: Flow Generator Platform Ratings (Time Series)



Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

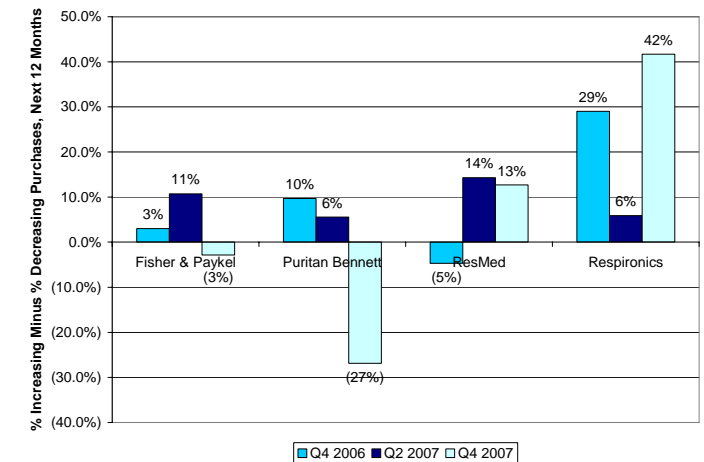
Consistent with the ratings, HMEs indicate that they intend to increase their purchases of Respironics flow generators more than any other companies' flow generators (54% of respondents expect to increase Respironics flow generator purchases vs. 13% that expect to decrease purchases). ResMed looks likely to hold market share while Fisher & Paykel and particularly Covidien's (COV) Puritan Bennett division look likely to lose market share.

Figure 10: In Next 12 Months Will Your Flow Generator Purchases Decrease, Increase, Or Stay Unchanged...



Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

Figure 11: Difference In % Of Respondents Increasing Vs. Decreasing Purchases (Time Series)

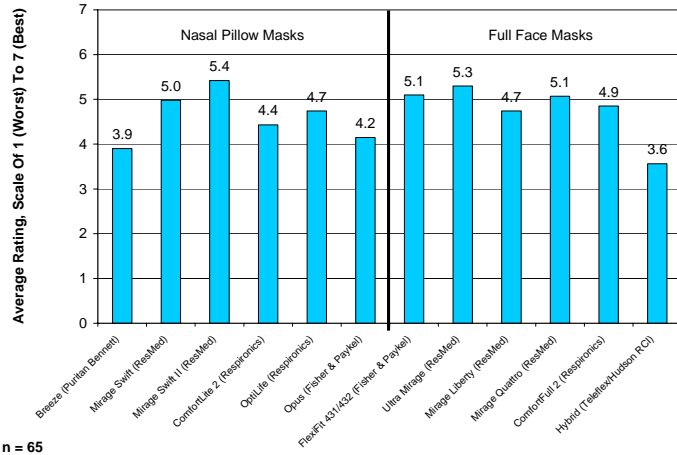


Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

...ResMed's Masks Were Rated Highest And ResMed And Resprionics Looks Likely To Continue To Gain Mask Market Share

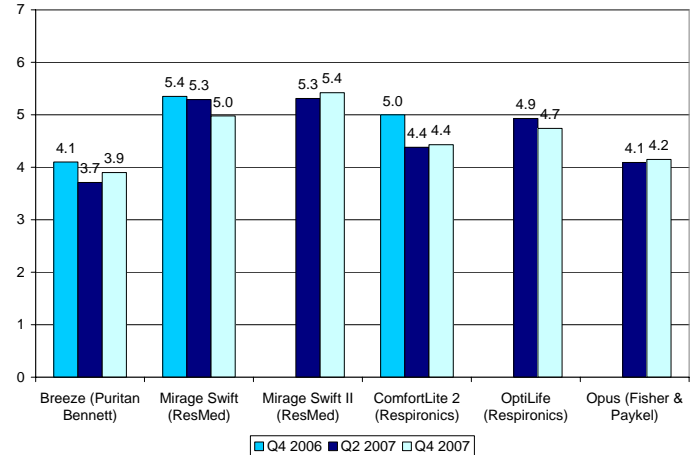
ResMed continues to have the best masks according to our survey. In the nasal pillow category, ResMed's Swift II was the highest rated at 5.4 (out of 7.0) followed by ResMed's original Swift (5.0) and Resprionics' OptiLife (4.7). These results are consistent with our prior HME surveys though the Swift II has supplanted the Swift as the leading mask and Resprionics' OptiLife rating dropped slightly. In the full face mask category, ResMed's Ultra Mirage was the highest rated at 5.3 followed by ResMed's Quattro (5.1) and Fisher & Paykel's FlexiFit 431/432 masks.

Figure 12: Mask Ratings



Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

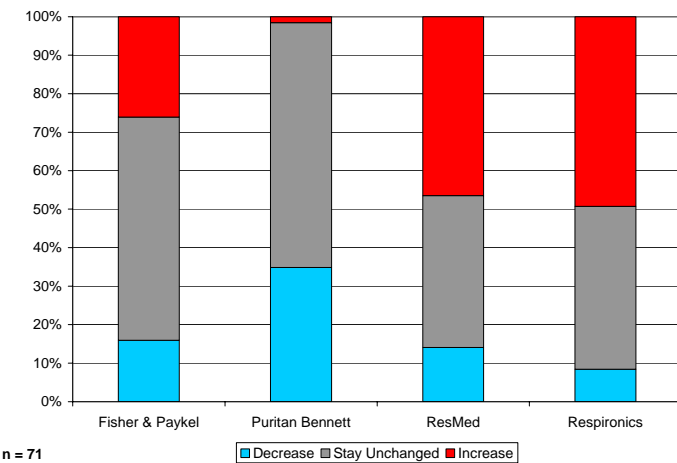
Figure 13: Mask Ratings (Time Series)



Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

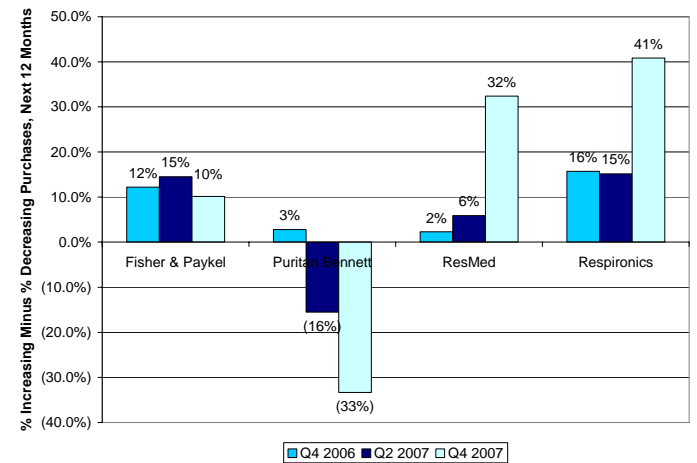
Consistent with the ratings, HMEs indicate that they intend to increase their purchases of both Resprionics and ResMed masks more than other companies' masks (49% of respondents expect to increase Resprionics mask purchases vs. 9% that expect to decrease purchases; 47% of respondents expect to increase ResMed mask purchases vs. 14% that expect to decrease purchases). Fisher & Paykel looks likely to hold market share while Covidien's (COV) Puritan Bennett division look likely to lose significant market share.

Figure 14: In Next 12 Months Will Your Mask Purchases Decrease, Increase, Or Stay Unchanged...



Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

Figure 15: Difference In % Of Respondents Increasing Vs. Decreasing Purchases (Time Series)

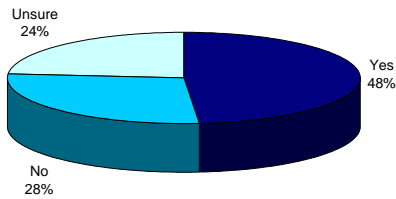


Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

...HMEs Generally Believe That Unattended Home Testing For Sleep Apnea Is Effective And Nearly Half Plan To Administer Home Based Tests

When asked about home diagnosis of obstructive sleep apnea, nearly half of respondents indicated that they believe that home-based testing is reliable and nearly half also expect to begin to administer home tests if CMS changes its coverage policy to allow home testing.

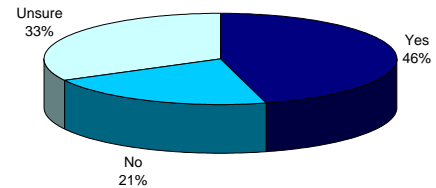
Figure 16: Do You Believe That Unattended Home Testing For Sleep Apnea Is Reliable?



n = 68

Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

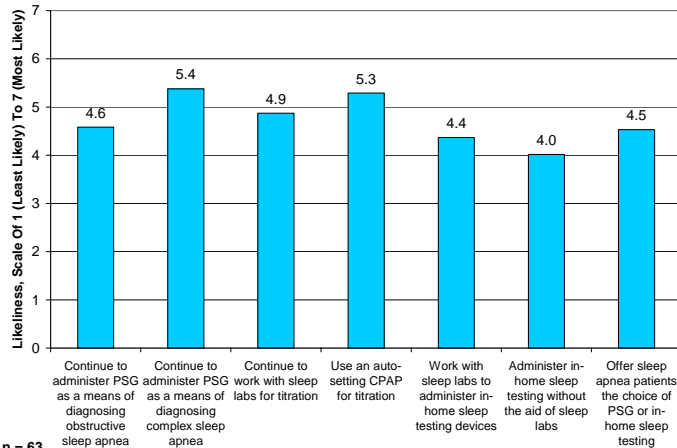
Figure 17: If Medicare Allows Home Testing For Sleep Apnea Do You Plan To Offer Home Tests?



n = 70

Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

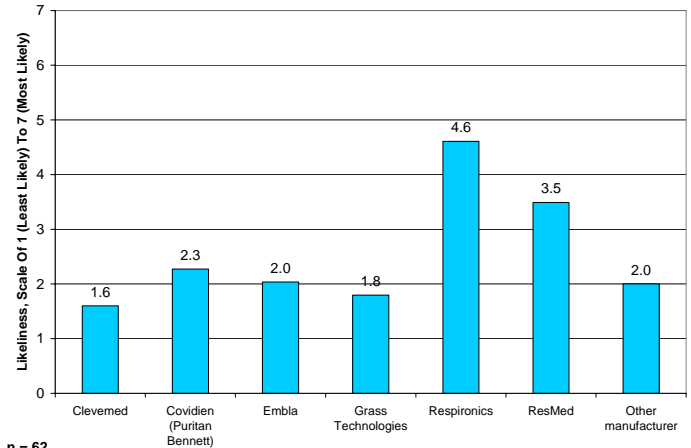
Figure 18: If Home Testing Is Implemented, How Important Are The Following?



n = 63

Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

Figure 19: How Likely Are You To Purchase Home Testing Devices From The Following Companies?



n = 62

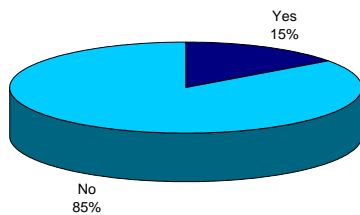
Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

Negative Pressure Wound Therapy (NPWT) Questions

...A Minority Of HMEs Participate Offer Negative Pressure Wound Therapy (NPWT) But More Plan To Offer It In The Next 6 Months

The HMEs in our survey are generally not in the NPWT market (only 15% currently offer NPWT products) but more plan to enter in the next 6 months (13% expect to begin offering NPWT products). This is not surprising given the recent surge in the number of manufacturers offering NPWT products.

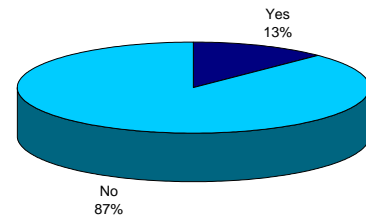
Figure 20: Do You Currently Offer NPWT?



n = 100

Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

Figure 21: Do You Plan To Begin Offering NPWT In Next 6 Months?



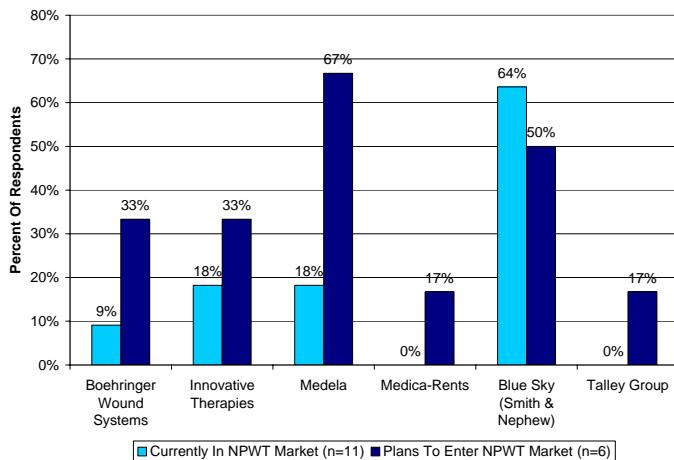
n = 87

Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

...Blue Sky/Smith & Nephew and Medela Are Most Common Suppliers Of NPWT; HMEs Target Acute and Extended Care NPWT Markets Along With Home NPWT Markets

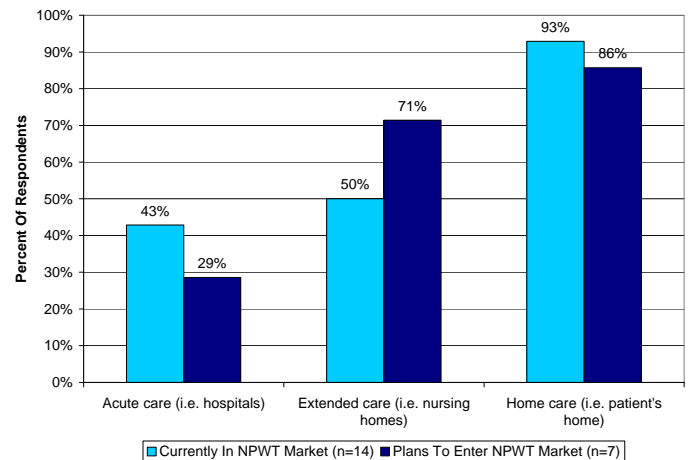
Most HMEs are purchasing NPWT products from Blue Sky/Smith & Nephew and Medela. And many HMEs are targeting the acute and extended care markets as well as the home markets with NPWT products. We note that while CMS data shows that HMEs have struggled to collect Medicare payments for home-based NPWT (rejection rates are >75%), payments in the other care settings are from the facilities not insurers which may make it easier to collect payments.

Figure 22: From Which Supplier Do You Purchase NPWT Pumps?



Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

Figure 23: In Which Care Settings Do You Offer NPWT?

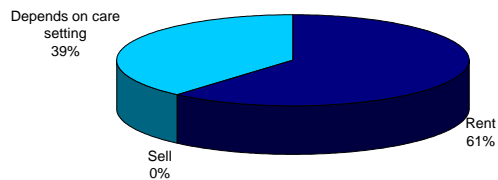


Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

...HMEs Offer NPWT Through Both Rental And Sales Models Depending On Care Settings And Rental Rates Are Likely Well Below KCI's

We asked HMEs about their sales model for NPWT products to determine if they were renting or selling the NPWT pumps. The majority of HMEs currently offering NPWT products rent the pumps (61%) although 39% said that the sales model depends on the care setting. Interestingly, HMEs that are planning to enter the market seem to show a greater interest in selling the pumps; 29% expect to sell the pumps and 71% said the sales model depends on the care setting. While we think it makes more sense economically for HMEs to rent pumps (revenue per pump may be two or more times higher) and believe that most customers are used to KCI's rental model, it is possible that more cost sensitive customers such as extended care facilities may be interested in purchasing rather than renting pumps.

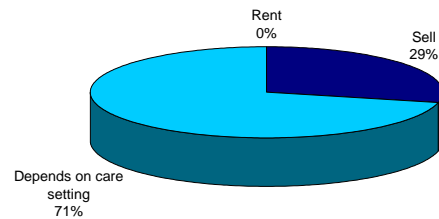
Figure 24: Sales Model For HMEs Currently In NPWT Market



n = 13

Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

Figure 25: Sales Model For HMEs Planning To Enter NPWT Market In Next 6 Months

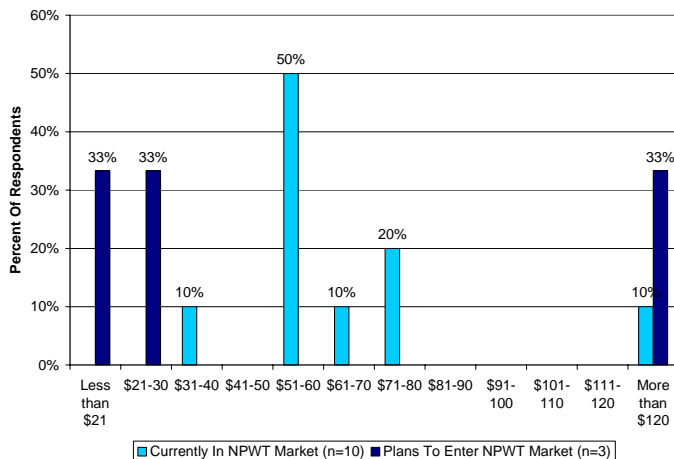


n = 7

Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

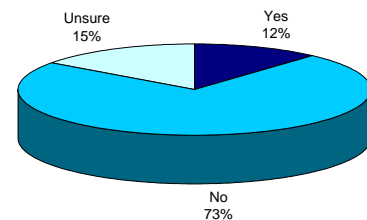
We asked the HMEs about the rental rates that they charge (or intend to charge) for NPWT pumps. While the sample size was small (13 total responses) and there was a wide range of responses, the average was \$63 per day. We believe that this is well below the rates that KCI charges (our checks indicate that in the hospital setting KCI charges around \$100 per day). We think that this could result in price pressure for KCI.

Figure 26: What Is Your Daily NPWT Rental Rate?



Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

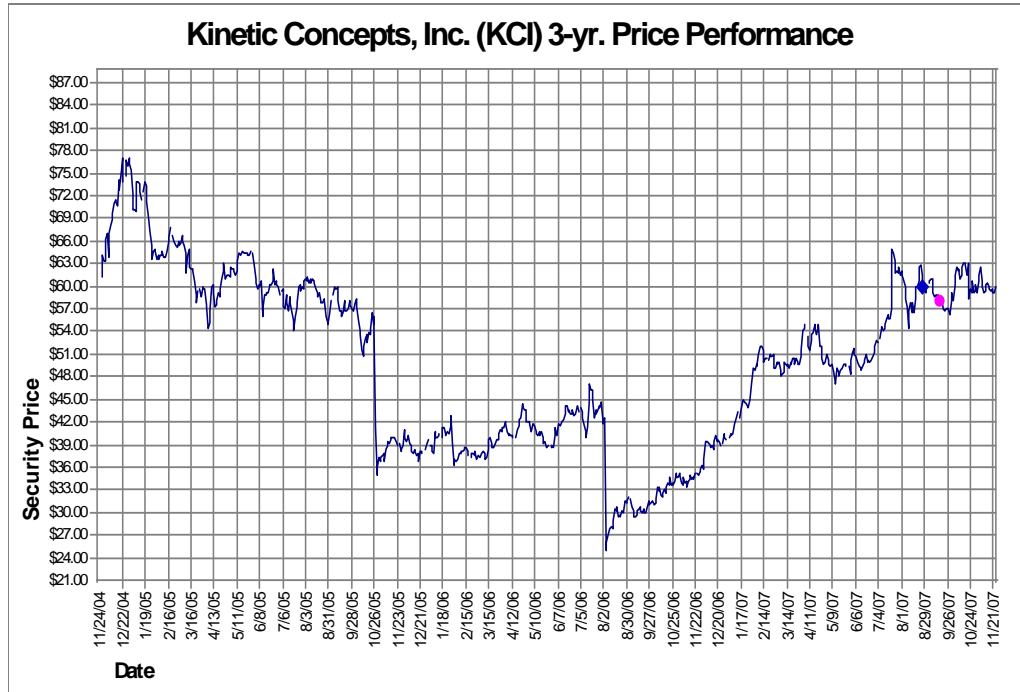
Figure 27: Do You Intend To Participate In Medicare's Competitive Bidding Program For NPWT Products?



n = 93

Source: Wachovia Capital Markets, LLC Q4 2007 HME Survey

Required Disclosures



	Date	Publication Price (\$)	Rating Code	Val. Rng. Low	Val. Rng. High	Close Price (\$)
	8/27/2007		Matson			
◆	8/28/2007	NA	2	NE	NE	59.89
●	9/17/2007	58.11	2	60.00	65.00	58.11

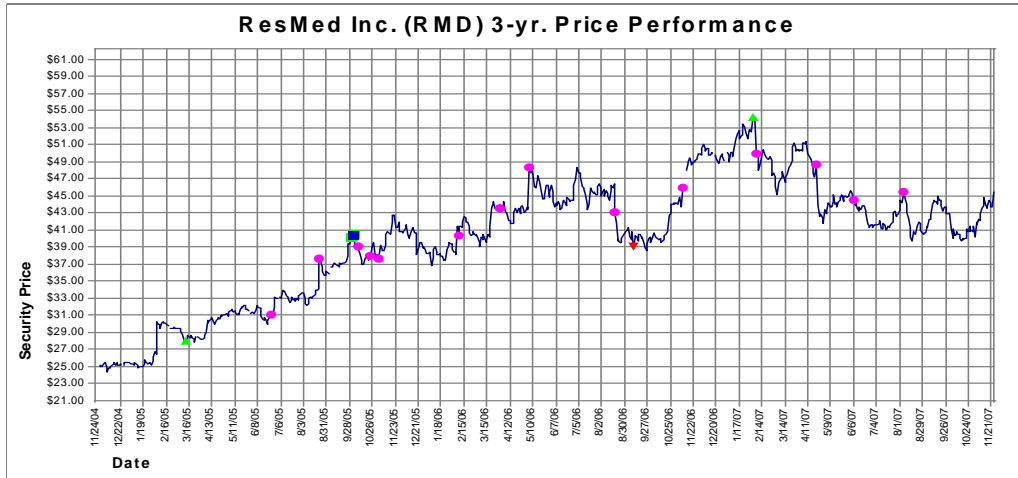
Source: Wachovia Capital Markets, LLC estimates and Reuters data

Symbol Key

- ▼ Rating Downgrade
- ▲ Rating Upgrade
- Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- Analyst Change
- Split Adjustment

Rating Code Key

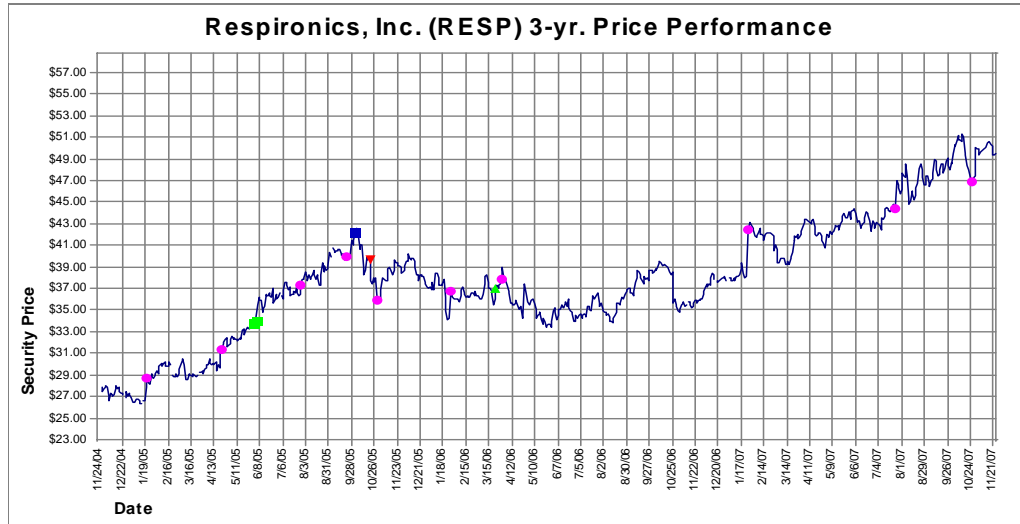
- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate



	Date	Publication Price (\$)	Rating Code	Val. Rng. Low	Val. Rng. High	Close Price (\$)
	11/24/2004		Huber			
	11/24/2004	NA	2	23.50	26.00	24.86
▲	3/11/2005	NA	1	32.00	33.50	28.00
●	6/23/2005	NA	1	33.50	35.00	31.00
●	8/23/2005	NA	1	39.00	40.50	37.68
□	10/3/2005		2 for 1 stock split.			
■	10/3/2005		Matson			
●	10/7/2005	NA	1	78.00	81.00	39.04
●	10/24/2005	NA	1	39.00	40.50	38.00
●	11/3/2005	NA	1	42.00	44.00	37.60
●	2/8/2006	NA	1	46.00	48.00	40.41
●	3/30/2006	NA	1	48.00	50.00	43.48
●	5/5/2006	NA	1	49.00	52.00	48.36
●	8/18/2006	NA	1	52.00	55.00	43.10
▼	9/11/2006	NA	2	40.00	44.00	39.04
●	11/9/2006	NA	2	42.00	47.00	46.02
▲	2/2/2007	NA	1	61.00	66.00	54.26
●	2/7/2007	NA	1	60.00	65.00	50.00
●	4/23/2007	NA	1	50.00	55.00	48.64
●	6/6/2007	NA	1	52.00	56.00	44.44
●	8/7/2007	NA	1	50.00	54.00	45.40

Source: Wachovia Capital Markets, LLC estimates and Reuters data

Symbol Key		Rating Code Key	
▼ Rating Downgrade	◆ Initiation, Resumption, Drop or Suspend	1 Outperform/Buy	SR Suspended
▲ Rating Upgrade	■ Analyst Change	2 Market Perform/Hold	NR Not Rated
● Valuation Range Change	□ Split Adjustment	3 Underperform/Sell	NE No Estimate



Date	Publication Price (\$)	Rating Code	Val. Rng. Low	Val. Rng. High	Close Price (\$)
11/24/2004		Huber			
11/24/2004	NA	1	31.00	34.00	27.74
1/21/2005	NA	1	35.50	37.00	28.74
4/22/2005	NA	1	37.00	39.00	31.30
6/2/2005		2:1 stock split.			
7/28/2005	NA	1	41.00	43.00	37.33
9/22/2005	NA	1	44.00	46.00	39.99
10/3/2005		Matson			
10/20/2005	NA	2	38.00	40.00	39.63
10/28/2005	NA	2	37.00	39.00	35.95
1/27/2006	NA	2	36.00	40.00	36.71
3/23/2006	NA	1	42.00	44.00	37.04
3/30/2006	NA	1	44.00	46.00	37.87
1/25/2007	NA	1	46.00	50.00	42.46
7/25/2007	NA	1	50.00	54.00	44.35
10/25/2007	46.81	1	51.00	55.00	46.81

Source: Wachovia Capital Markets, LLC estimates and Reuters data

Symbol Key		Rating Code Key			
▼	Rating Downgrade	◆	Initiation, Resumption, Drop or Suspend	1	Outperform/Buy
▲	Rating Upgrade	■	Analyst Change	2	Market Perform/Hold
●	Valuation Range Change	□	Split Adjustment	3	Underperform/Sell
				SR	Suspended
				NR	Not Rated
				NE	No Estimate

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- 2) No part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by me in this research report.

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- 1 = Outperform:** The stock appears attractively valued, and we believe the stock's total return will exceed that of the market over the next 12 months. BUY
- 2 = Market Perform:** The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD
- 3 = Underperform:** The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

SECTOR RATING

- O = Overweight:** Industry expected to outperform the relevant broad market benchmark over the next 12 months.
- M = Market Weight:** Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.
- U = Underweight:** Industry expected to underperform the relevant broad market benchmark over the next 12 months.

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- V = A stock is defined as volatile if the stock price has fluctuated by +/-20% or greater in at least 8 of the past 24 months or if the analyst expects significant volatility. All IPO stocks are automatically rated volatile within the first 24 months of trading.**

As of: November 27, 2007

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