Siddharth Rajeev, B.Tech, MBA, CFA

Fundamental Research Corp.
Investment Analysis for Intelligent Investors

October 16, 2019

Frontenac Mortgage Investment Corporation – 5.88% Yield to Investors in 2018

Sector/Industry: Real Estate Mortgages

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Offering Summary	
Issuer	Frontenac Mortgage Investment Corporation
Securities Offered	Common Shares
Unit Price	NAV
Minimum Subscription	$5,000
Distribution to Investors	Monthly
Redemption	Annual Redemption - Nov 30th (No penalties for early redemption)
Management Fee	2% of the AUM
Sales Commissions	N/A
Auditor	MNP LLP

FRC Rating	
Yield (2019-2020)	5.00% - 5.50% p.a.
Rating	3+
Risk	2

*see back of report for rating definitions

Highlights

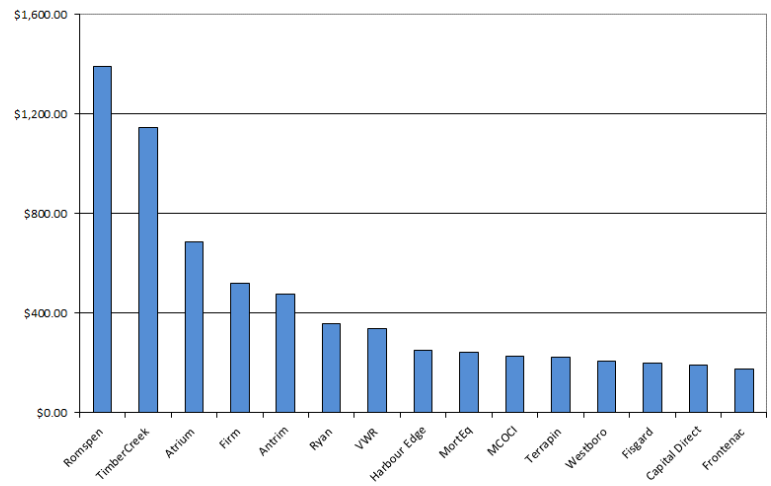
- At the end of 2018, Frontenac Mortgage Investment Corporation ("MIC", "Frontenac", "company") had $181 million in mortgage receivables (net) across 577 properties, down 5% from $190 million across 638 properties at the end of 2017. The decline was a result of $35 million in redemptions in 2018.
- In 2018, the MIC generated $18.13 million in revenues (up 12% YoY), and reported $11.33 million in net income (up 36% YoY) – both figures are the highest ever since inception in 2004.
- The dividend yield increased from 4.22% in 2017, to 5.88% in 2018.
- We believe a key differentiator of the MIC is that it is focused on first mortgages secured by residential properties outside of the Greater Toronto Area, largely centering on rural areas and smaller urban centers. At the end of 2018, the portfolio's exposure to residential built properties was 42.4% (versus 48.3% at the end of 2017). Overall, we believe the portfolio's risk profile remained unchanged on a YoY basis.
- The percentage of impaired mortgages in the portfolio increased significantly in 2018, from 4.2% ($7.93 million / 24 mortgages) to 12.2% ($22.04 million / 27 mortgages). The significant increase was due to the addition of a $16.1 million legacy residential development mortgage, for which the manager stated they had secured a purchaser for the property and expects to recoup all of its capital from the mortgage. Excluding the large mortgage, the percentage of impaired mortgages in 2018 would be 3.2% ($5.9 million / 26 mortgages), a YoY decrease.
- The portfolio had approximately 2.5% ($4.83 million) past due but not impaired at the end of 2018, versus 4.8% ($9.05 million) at the end of 2017.
- At the end of 2018, the debt to capital was 7.2% versus 8.3% at the end of 2017).

FRC Fundamental Research Corp.

Frontenac in Top 15

We estimate that the total Assets Under Management (“AUM”) at the end of 2018, of the largest 15 largest Mortgage Investment Entities (“MIEs”), was $6.64 billion. We estimate there are approximately 200 MICs in the country, with a total portfolio size of approximately $12.5 billion. **Frontenac, with a portfolio of $181 million, was the 15th largest MIE in the country at the end of 2018.**

Top 15 Largest MIEs (in $, millions)

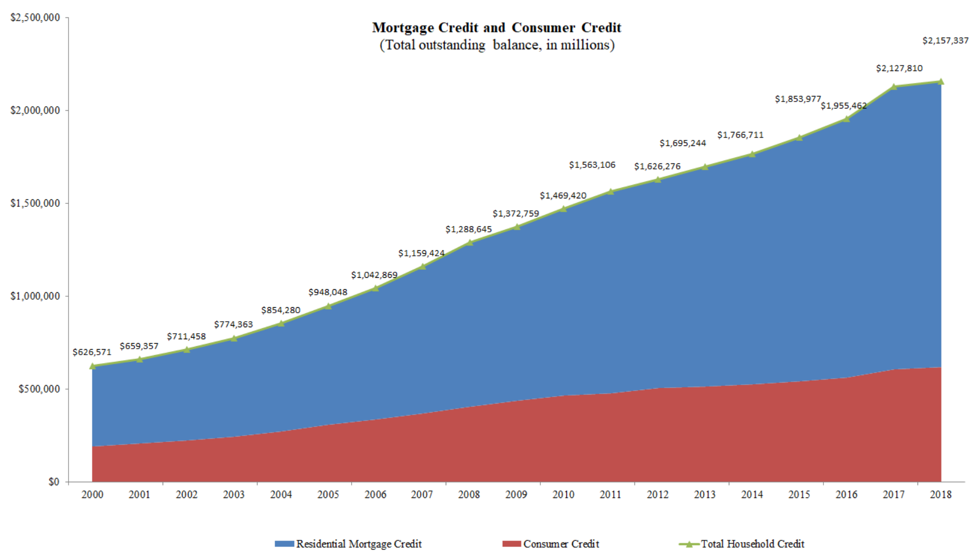


*Romspen’s portfolio only includes the Canadian investments

Source: FRC / Multiple Sources

Update on the Mortgage Industry

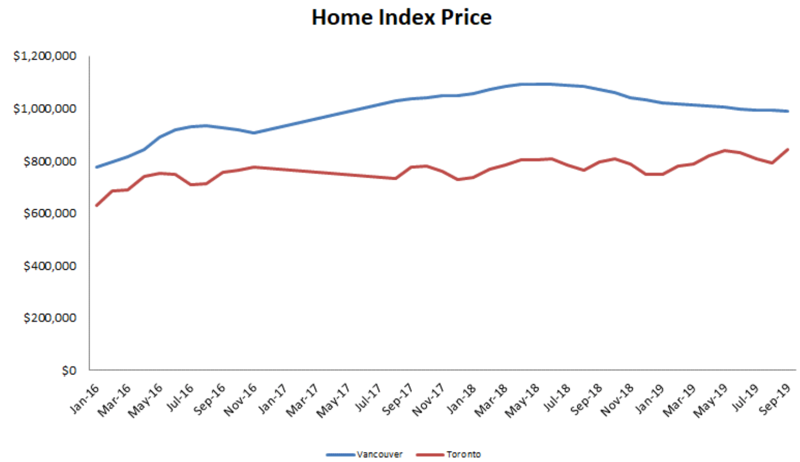
The total debt (mortgage and consumer credit) held by Canadians at the end of December 2018 was $2.16 trillion, up 1.4% YoY. **The total mortgage credit ($1.54 trillion) grew 1.1% YoY.** At the end of December, mortgage credit accounted for 71%, and consumer credit accounted for the remaining 29% of the total debt.



Data Source: Statistics Canada

The real estate market **experienced a dramatic slowdown in 2018,** primarily due to the tighter lending policies by the banks (especially the stress test that was introduced in early 2018), and a rising interest rate environment, followed a decline in real estate prices.

The following chart shows average home prices in Vancouver and Toronto.



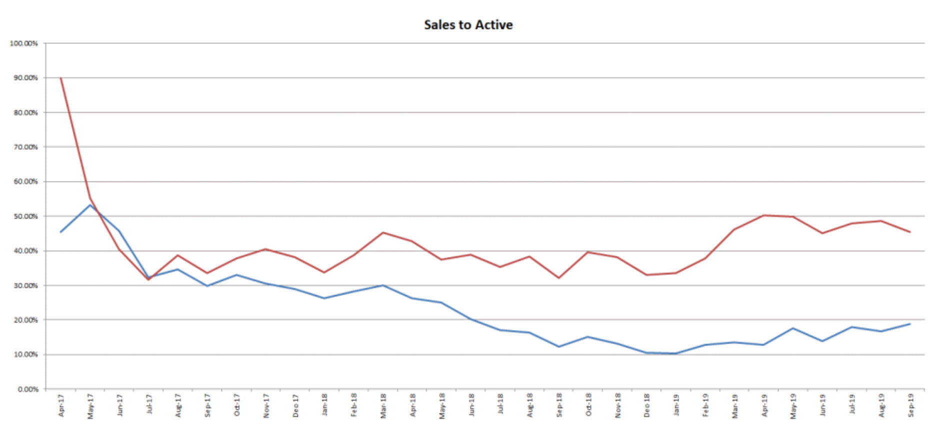
Source: TREB and REBGV

Toronto MLS sales remain healthy, and were up 21% YoY in September 2019. Sales have been up YoY every month since April 2019. The average price was up 6% YoY in September 2019.

Toronto	Jul-18	Jul-19	YoY	Aug-18	Aug-19	YoY	Sep-18	Sep-19	YoY
Residential Sales	6,961	8,595	23%	6,839	7,711	13%	6,455	7,825	21%
New Listings	13,868	14,393	4%	12,166	11,789	-3%	15,920	15,611	-2%
Active Listings	19,725	17,938	-9%	17,864	15,870	-11%	20,089	17,254	-14%
Sales to Listings	35.29%	47.92%		38.28%	48.59%		32.13%	45.35%	
MLS Home Price Index	$782,129	$806,755	3%	$765,270	$792,611	4%	$796,786	$843,115	6%

Source: Toronto Real Estate Board

The sales to active listings was 45% in September 2019, up from 32% in September 2018.



Source: TREB and REBGV

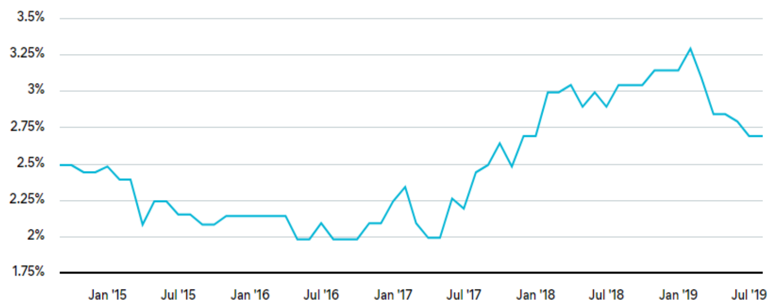
Default rates on residential mortgages remain low. The following table shows the average, minimum and maximum rates in Canada since 2005.

%	2005-2018 (Average)	LOW	HIGH	Dec-18
Canada	**0.31%**	**0.23%**	**0.45%**	**0.24%**
Atlantic	0.49%	0.36%	0.65%	0.52%
Quebec	0.30%	0.14%	0.39%	0.29%
Ontario	0.24%	0.09%	0.43%	0.10%
Manitoba	0.29%	0.19%	0.43%	0.37%
Saskatchewan	0.40%	0.20%	0.85%	0.85%
Alberta	0.43%	0.14%	0.84%	0.48%
British Columbia	0.29%	0.13%	0.49%	0.14%

Data Source: CMHC

We **expect reasonably strong markets** for residential mortgages in Toronto. This is likely to be partially offset by a lower interest rate environment. Despite the steady benchmark rate, mortgage rates in Canada have been declining (as shown below), primarily due to the overall weakness in the economy.

Three-Year Fixed Mortgage Rates



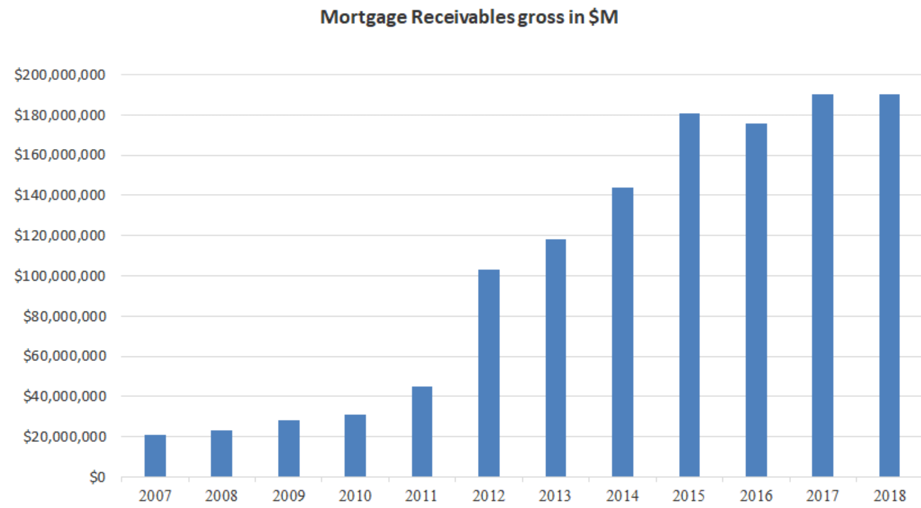
Source: Ratehub

The following section reviews Frontenac's 2018 results.

Portfolio Update

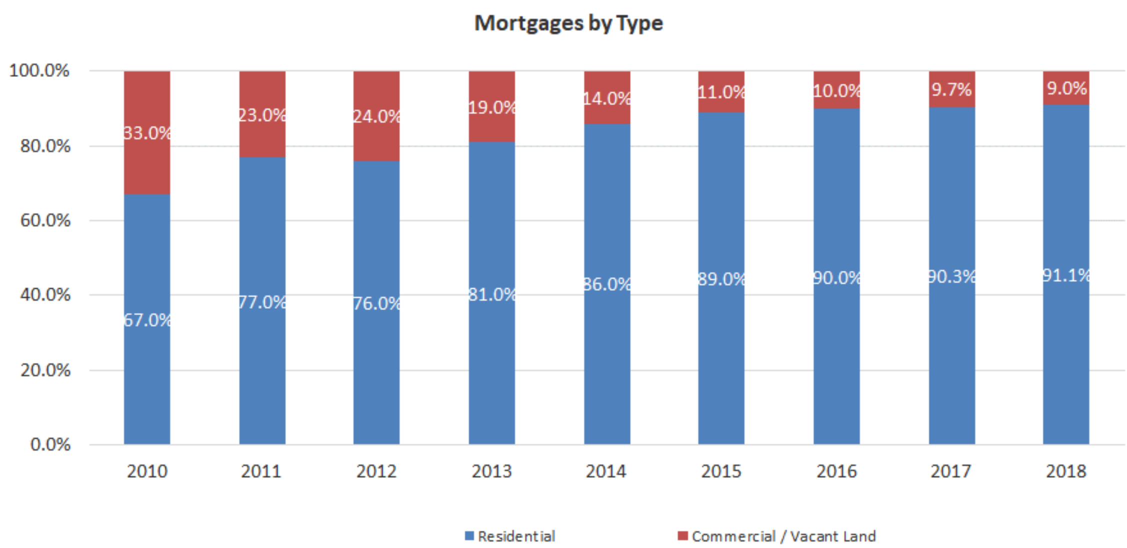
At the end of 2018, the MIC had $180 million in mortgage receivables (net) across 577 properties, down 5% from $190 million across 638 properties at the end of 2017. Our discussions with management indicated that the decline was a result of unusually large redemptions from financial advisors seeking more liquid private / publicly traded securities. Note that Frontenac's shares are only eligible for redemption, at the book value, on November 30th of every year. **In order to reduce concentration risk, management limits investment from each dealer / portfolio manager to 15% of net assets.**

Note that we are not overly concerned about the high redemptions in 2018, as it was not a result of the fund's performance. Also, we believe that investors are typically better off if a fund does not raise new equity capital. This is because, theoretically, new capital will likely prompt management to shift to higher risk loans. Also, undeployed capital can lead to a drag on performance. We also note that redemptions have been low in the first half of 2019.



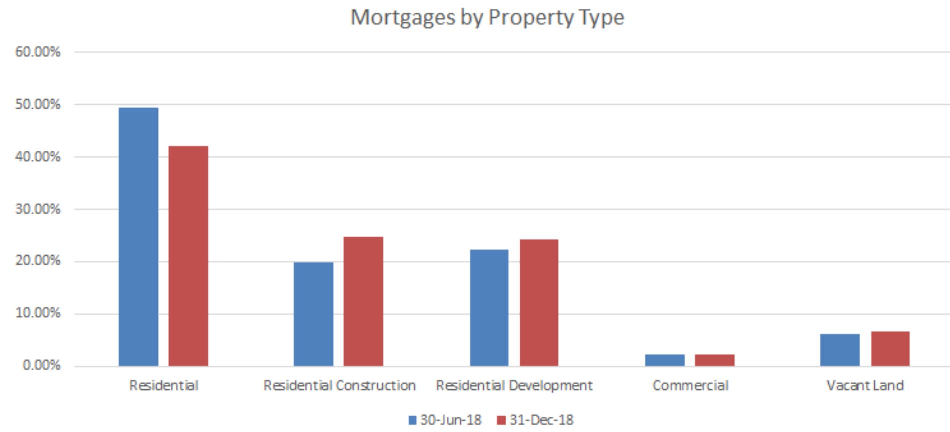
Data Source: Company

Mortgages by Type: At the end of 2018, approximately 91% of the mortgages were on residential properties (90% at the end of 2017), and 9% on commercial properties and vacant land.



Data Source: Company

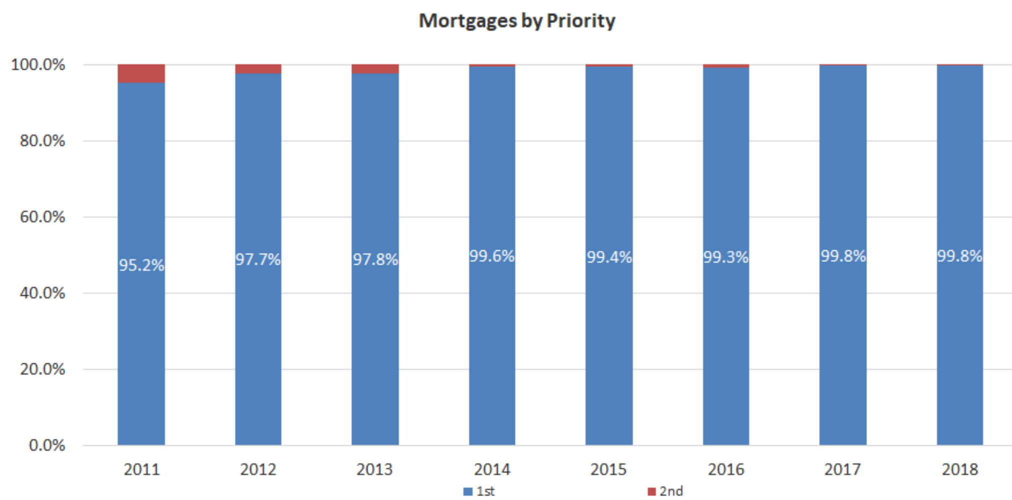
As a result of the significant redemptions, since June 30, 2018, the portfolio's exposure to residential built properties (which have relatively shorter-terms) declined from 49.50% to 41.98%, while the exposure to residential development properties increased from 22.33% to 24.36%, implying an overall increase in risk exposure.



Mortgages (Gross) -$M	30-Jun-18	31-Dec-18
Residential	$105	$77
Residential Construction	$42	$46
Residential Development	$47	$45
Commercial	$5	$4
Vacant Land	$13	$12
	$213	**$184**

Source: Company

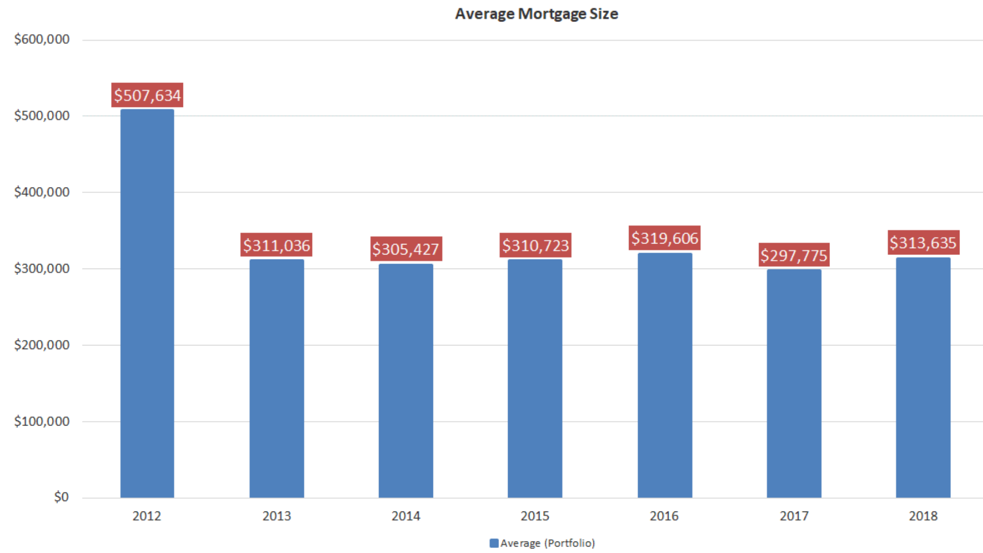
Mortgages by Priority: First mortgages accounted for 99.8% (unchanged) at the end of 2018.



Data Source: Company

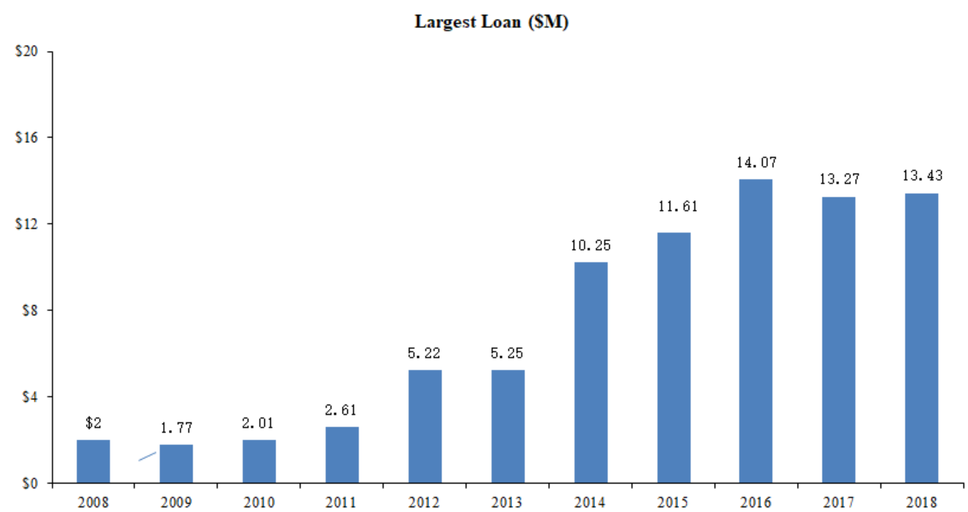
Mortgages by Region: At the end of 2018, approximately 99.9% of the portfolio was in ON. Management has not provided geographical distribution within ON.

Mortgages by Size: The average mortgage size at the end of 2018 was $314k, up 5% YoY. We estimate the average would be only $237k ($220k at the end of 2017) if the mortgages on development projects in the portfolio were removed.



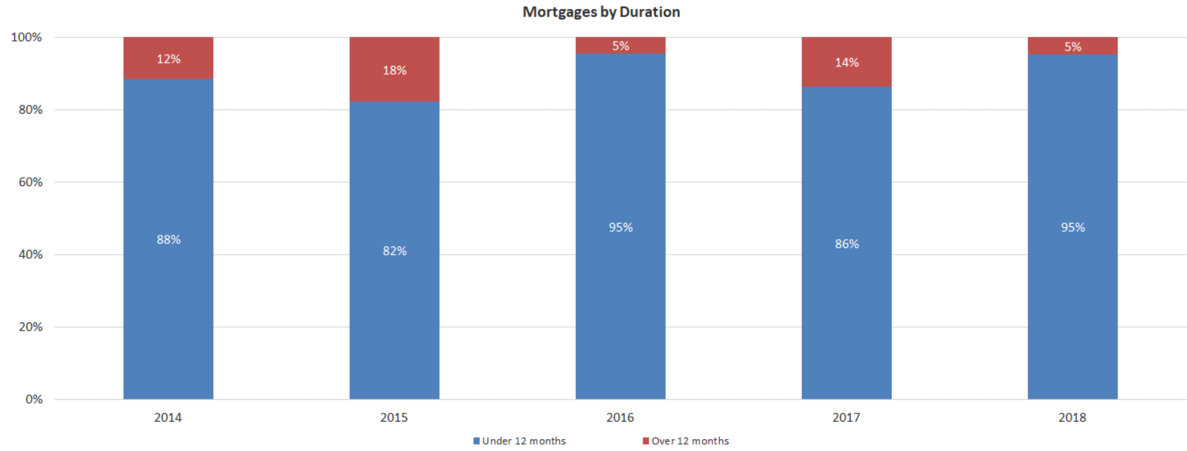
Data Source: Company

At the end of 2018, the largest loan in the portfolio was $13 million (unchanged). As mentioned in our initiating report, the size of large loans have been increasing in recent years because of development mortgages in the portfolio that were underwritten prior to 2014. The manager exited two such mortgages in 2018, bringing the number of legacy, development mortgages down to three. The Manager believes that it is highly likely that they will be able to exit two development mortgages by the end of 2019, bringing the total number outstanding down to one. Their intent is to redeploy the capital from the development mortgages into single family residential mortgages upon completion. As approximately 24.8% of the portfolio is exposed to legacy mortgages related to development projects, we believe the risk profile of the portfolio will continue to be relatively high until all of the existing large mortgages are exited.



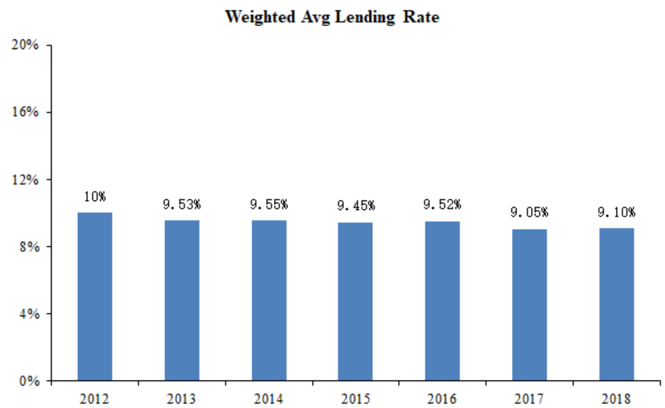
Data Source: Company

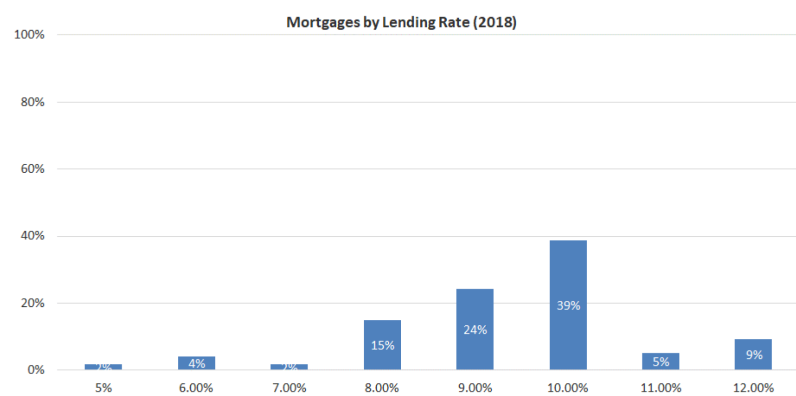
Mortgages by Duration: At the end of 2018, approximately 95% of the portfolio had terms of 12 months or less, versus 86% at the end of 2017. Management attributed this to a conscious decision to lower duration. Note that a lower duration generally implies lower risk.



Data Source: Company

Lending Rate: Approximately 78% (previously 74%) of the mortgages had rates between 8% and 10%. The weighted average rate increased YoY, as expected, from 9.05% to 9.10%.





Source: Company

Loan to Value (LTV): The MIC does not disclose weighted average LTV figures.

Overall, we believe the MIC portfolio's risk profile remained flat YoY. The risk profile will significantly decrease if the MIC is able to exit the two development mortgages, as indicated by the Manager, in 2019. The following chart summarizes the change in risk levels based on YoY changes in key parameters.

Parameter	Risk Profile
Total Portfolio Size	↓
Average Mortgage	↑
Diversification	-
Duration	↓
Priority	-
Property Type	↑

- red (green) indicates an increase (decrease) in risk level

Source: FRC

At the end of 2018, the fund had 5.93 million shares outstanding, down 3.5% YoY. The decline was due to $35 million in redemptions in 2018 (19% of invested capital), versus $18 million, or 10% of invested capital in 2017.

Financials

The MIC raises capital through its prospectus. Common shares are offered in BC, AB, SK, MB, ON, NS, NB, and NL (FundSERV code: WAR 110/111 / F Class). There are no sales commissions. There is no market or exchange that the shares trade on. They are eligible for redemption, at the book value, on November 30 of every year. As per the OM, the MIC will not have to redeem if there are redemption requests totaling more than 25% of the total number of shares outstanding per year. There is no penalty for early redemption. To meet redemption requests, the fund will have, at all times, at least 5% of its assets in cash.

In 2018, the MIC generated $18.13 million in revenues (up 12% YoY), and reported $11.33 million in net income (up 36% YoY).

Income Statement	2011	2012	2013	2014	2015	2016	2017	2018
Revenues								
Interest Income	$3,771,220	$7,187,719	$10,582,028	$13,139,636	$14,485,507	$17,580,995	$16,178,501	$18,134,892
Other Income								
	$3,771,220	**$7,187,719**	**$10,582,028**	**$13,139,636**	**$14,485,507**	**$17,580,995**	**$16,178,501**	**$18,134,892**
Expenses								
G&A	$422,733	$621,158	$761,581	$785,088	$768,929	$717,278	$730,422	$747,488
Management Fees	$800,627	$1,722,765	$2,409,867	$3,062,237	$3,531,737	$4,121,544	$4,229,612	$4,608,592
Loan Loss Provision	-$151,000	-$384,000	-$99,758	$603,555	$1,307,013	$1,662,654	$2,817,427	$738,184
Realized Losses	$271,336	$667,996	$237,243	$274,617				
Unrealized Loss in Investments		$277,000	$673,758					
Change in FV of Foreclosed Properties		-$141,000	$62,000	-$36,000	$20,479			
Interest on Loan Payable	$39,361	$18,569	$35,292	$226,764	$276,332	$168,271	$54,372	$707,639
	$1,383,057	**$2,782,488**	**$4,079,983**	**$4,916,261**	**$5,904,490**	**$6,669,747**	**$7,831,833**	**$6,801,903**
Net Income	**$2,388,163**	**$4,405,231**	**$6,502,045**	**$8,223,375**	**$8,581,017**	**$10,911,248**	**$8,346,668**	**$11,332,989**
Dividends	$2,388,163	$4,405,231	$6,502,045	$8,223,375	$8,581,017	$10,911,248	$9,362,668	$10,207,989
Net Asset Value	$30.000	$30.000	$30.000	$30.000	$30.000	$30.000	$29.835	$30.000
Shares Outstanding	1,534,943	3,328,364	4,102,680	4,610,052	5,651,215	6,396,798	6,141,401	5,926,249

YE – December 31st

Source: FRC / Data Source: Company

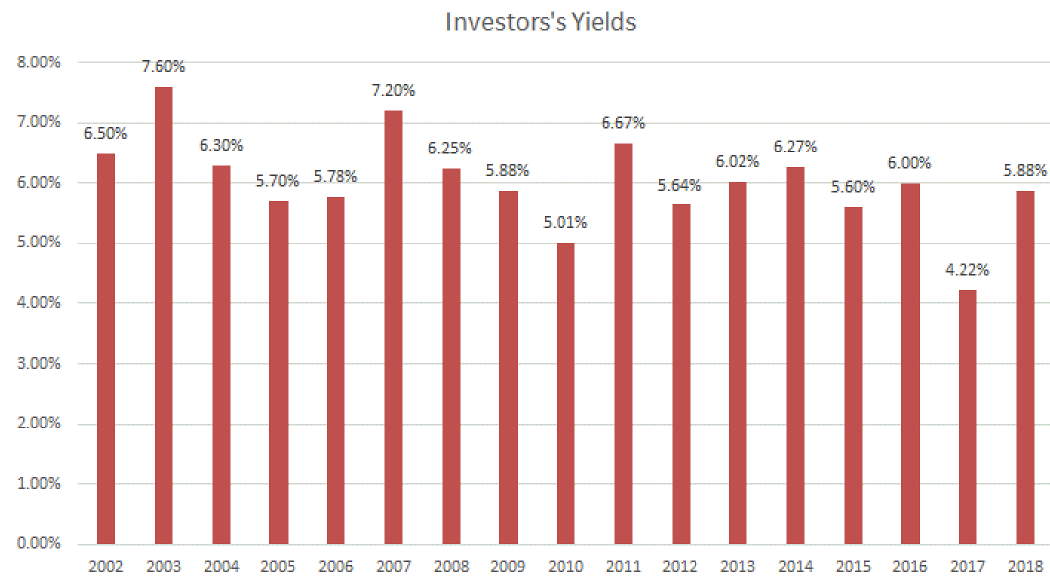
We estimate that interest income as a percentage of mortgage receivables was 9.78% in 2018, versus 8.85% in 2017. The dividend yield (dividends as a percentage of invested capital) increased from 4.98% in 2017, to 5.64% in 2018.

% of Mortgage Receivable	2011	2012	2013	2014	2015	2016	2017	2018
Interest Income	9.93%	9.71%	9.58%	10.04%	8.93%	9.87%	8.85%	9.78%
Interest Income + Others	**9.93%**	**9.71%**	**9.58%**	**10.04%**	**8.93%**	**9.87%**	**8.85%**	**9.78%**
Less:								
Management Fee	-2.11%	-2.33%	-2.18%	-2.34%	-2.18%	-2.31%	-2.31%	-2.48%
G&A Expenses	-1.11%	-0.84%	-0.69%	-0.60%	-0.47%	-0.40%	-0.40%	-0.40%
Realized and Unrealized Losses	-0.32%	-0.57%	-0.79%	-0.64%	-0.82%	-0.93%	-1.54%	-0.40%
Interest	-0.10%	-0.03%	-0.03%	-0.17%	-0.17%	-0.09%	-0.03%	-0.38%
Net	6.29%	5.95%	5.89%	6.28%	5.29%	6.12%	4.56%	6.11%
Investors' Returns (% of Invested Capital)	**6.20%**	**6.04%**	**5.83%**	**6.29%**	**5.58%**	**6.04%**	**4.98%**	**5.64%**

Note that the above figures may be slightly different from the figures reported by Frontenac due to the difference in the method of calculation. We used the average of the opening balance, and year-end balance of the mortgages outstanding, and invested capital, to arrive at the above figures.

Source: FRC / Data Source: Company

The rate of return to investors, as calculated by the Manager, is show below:



Source: Manager

In 2018, the MIC had $1.14 million in realized losses, or 0.62% of mortgage receivables (0.59% in 2017). At the end of the year, a loan loss provision of $3.10 million, or 1.71% of the portfolio, was assigned (1.84% at the end of 2017). We estimate that comparable MICs typically assign 0.5% - 1.25% of their portfolios to loan loss provisions.

	2011	2012	2013	2014	2015	2016	2017	2018
Actual Losses	271,336	667,996	237,243	274,617	1,175,062	657,402	1,071,232	1,142,691
Actual Losses (% of mortgage receivable)	0.71%	0.90%	0.21%	0.21%	0.72%	0.37%	0.59%	0.62%
Distributions	$2,388,163	$4,405,231	$6,502,045	$8,223,375	$8,581,017	$10,911,248	$9,362,668	$10,207,989
Reinvested	$2,170,541	$3,325,297	$4,718,760	$5,610,900	$5,468,128	$6,410,931	$5,182,391	$5,631,065
Reinvested (as a % of Distributions)	91%	75%	73%	68%	64%	59%	55%	55%
Redemptions	$1,093,192	$14,169,752	$7,839,097	$9,506,183	$6,870,590	$13,245,532	$18,459,102	$35,192,790
Redemption (% of invested capital)	3%	19%	7%	7%	4%	7%	10%	19%
Loan loss provision (year/quarter ended)	-	$249,000	$13,242	$616,797	$748,748	$1,754,000	$3,500,195	$3,095,688
Provision % of Receivable	0.00%	0.24%	0.01%	0.43%	0.41%	1.00%	1.84%	1.71%

Data Source: Company

The percentage of impaired mortgages in the portfolio increased significantly in 2018 from 4.2% ($7.93 million / 24 mortgages) to 12.2% ($22.04 million / 27 mortgages). The significant increase was due to the Power of Sale right executed by the manager on one of its larger, legacy residential development mortgages. The manager has secured a purchaser for the property and expects to recoup its capital in full in 2019. In addition, the portfolio had approximately 2.5% ($4.83 million) past due, but not impaired, at the end of 2018, versus 4.8% ($9.05 million) at the end of 2017.

Past Due / Not Impaired	2017	2018
1 - 30 days	$2,658,036	$2,794,179
31 - 90 days	$525,474	$1,224,841
90+ days	$5,871,121	$808,907
Total	**$9,054,631**	**$4,827,927**

Past Due / Not Impaired as a % of Mortg Receivable	2017	2018
1 - 30 days	1.40%	1.54%
31 - 90 days	0.28%	0.68%
90+ days	3.09%	0.45%
Total	**4.77%**	**2.54%**

Past Due and Impaired	2011	2012	2013	2014	2015	2016	2017	2018
#	10	12	6	8	17	27	24	27
Amount	$2,862,240	$2,589,541	$1,832,867	$9,036,000	$8,070,000	$10,277,933	$7,930,370	$22,043,064
% of Mortgage Recivable	6.4%	2.5%	1.6%	6.3%	4.5%	5.8%	4.2%	12.2%
FV of Collateral							$9,524,000	$29,443,500
LTV							83.3%	74.9%

Past Due and Impaired	2017	2018	% of Total
Commercial		$537,996	2%
Residential		$3,615,332	16%
Residential Construction		$813,584	4%
Residential Development		$16,142,873	73%
Vacant Land		$933,278	4%
		$22,043,063	**100%**
Total Past Due	$16,985,001	$26,870,991	
% of Mortgage Recivable	8.9%	14.8%	

Data Source: Company

At the end of 2018, the MIC had $181 million (net) in mortgage receivables, down 4.7% YoY. **Management's goal is to grow its portfolio by approximately $15 million by the end of 2019.**

Balance Sheet	2012	2013	2014	2015	2016	2017	2018
Assets							
Cash	$8,531	$2,291	$8,007	$38,090	$8,026,202	$0	$45,324
Due from Administrator in Trust	$57,748	$1,945,120	$65,932	$396,546	$1,234,204	$574,788	$120,053
Interest Receivable	$2,575,519	$4,622,378	$5,162,051	$3,657,636	$7,736,337	$10,251,803	$11,194,987
Prepaid Expense	$16,500	$15,571	$17,005	$26,550	$28,984	$16,200	$16,200
Foreclosed	$424,256	$917,083	$789,680				
Investments	$587,155						
Mortgage Investments (net)	$103,049,689	$117,882,778	$143,856,080	$180,530,085	$175,783,333	$189,980,578	$180,967,671
	$106,719,398	**$125,385,221**	**$149,898,755**	**$184,648,907**	**$192,809,060**	**$200,823,369**	**$192,344,235**
Liabilities							
LOC	$5,950,000	$1,920,000	$9,540,000	$14,860,000		$16,580,000	$13,880,000
Bank Debt						$79,627	
Payable	$212,905	$203,854	$355,664	$180,900	$483,479	$621,514	$508,161
Prepaid Mortgage Payments	$705,518	$180,909	$1,701,452	$71,465	$421,562	$316,111	$168,609
	$6,868,423	$2,304,763	$11,597,116	$15,112,365	$905,041	$17,597,252	$14,556,770
Net Asset	$99,850,975	$123,080,458	$138,301,639	$169,536,542	$191,904,019	$183,226,117	$177,787,465
SE + Liabilities	**$106,719,398**	**$125,385,221**	**$149,898,755**	**$184,648,907**	**$192,809,060**	**$200,823,369**	**$192,344,235**
Debt to Capital	5.6%	1.5%	6.5%	8.1%	0.0%	8.3%	7.2%
Debt as a % of Mortgage Outstanding	5.8%	1.6%	6.6%	8.2%	0.0%	8.8%	7.7%
Interest Coverage Ratio	238.2	185.2	37.3	32.1	65.8	154.5	17.0

Data Source: Financial Statements

The company has a credit facility with RBC for $29 million at the bank prime rate plus 1% p.a. At the end of 2018, the outstanding balance was $13.88 million, implying a debt to capital of 7.2% (8.3% at the end of 2017). Management intends to keep debt to capital under 15%.

We estimate that comparable MICs typically use debt levels ranging between 20% and 40%. **The interest coverage ratio was strong at 155x in 2017.** We note that it is not uncommon for MICs focused on first mortgages to not use much leverage; such MICs typically use debt to meet immediate cash requirements, and not as a strategy to enhance returns. These funds adopt this strategy to ensure that their risk profile is very low.

Risk

Investors are exposed to the following key risks:

- Loans are short term and need to be sourced and replaced quickly.
- Timely deployment of capital is crucial.
- A drop in housing prices will result in higher LTVs, as the value of collateral decreases.
- Shareholders' principal is not guaranteed, as the NAV per share could decrease from current levels (as a result of loan losses). Shareholders are also not guaranteed minimum distributions.
- Key person risks exist as Matthew Robinson controls and owns 100% of the voting shares of the Manager and the Administrator. However, note that the MIC has the right to appoint a new Manager and Administrator. Shares held by investors have voting rights.
- Although the MIC's primary focus is on first mortgages, it may invest in second mortgages (up to a maximum of 10%) which carry higher risk.
- The fund will only accept redemption requests once a year.

Rating

We are maintaining our overall rating of 3+, and a risk rating of 2.

FRC Rating	
Yield (2019-2020)	5.00% - 5.50% p.a.
Rating	3+
Risk	2

As we expect reasonably strong housing markets for the MIC's focus areas, we believe the MIC will have a robust pipeline for new originations. Also, as management is focused on exiting its legacy development projects, we expect the MIC's risk profile to decline if management is successful in exitsing these projects without any significant losses. We expect investors' yield in 2019, and 2020, to be in the 5.00% - 5.50% p.a. range.

Fundamental Research Corp. Rating Scale:

Rating – 1: Excellent Return to Risk Ratio
Rating – 2: Very Good Return to Risk Ratio
Rating – 3: Good Return to Risk Ratio
Rating – 4: Average Return to Risk Ratio
Rating – 5: Weak Return to Risk Ratio
Rating – 6: Very Weak Return to Risk Ratio
Rating – 7: Poor Return to Risk Ratio
A "+" indicates the rating is in the top third of the category, A "-" indicates the lower third and no "+" or "-" indicates the middle third of the category.

Fundamental Research Corp. Risk Rating Scale:
1 (Low Risk)
2 (Below Average Risk)
3 (Average Risk)
4 (Speculative)
5 (Highly Speculative)

FRC Distribution of Ratings			
Rating - 1	0%	Risk - 1	0%
Rating - 2	30%	Risk - 2	8%
Rating - 3	47%	Risk - 3	41%
Rating - 4	9%	Risk - 4	33%
Rating - 5	4%	Risk - 5	8%
Rating - 6	1%	Suspended	10%
Rating - 7	0%		
Suspended	10%		

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