

## The ABC's of Commercial Real Estate – CDO's

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- Moderator:
- Joseph Philip Forte, Esq, Partner, Alston & Bird
  
- Panelists:
- Darren Esser, Vice President, Wachovia Securities
  
- Hugh Hall, Chief Operating Officer, Gramercy Capital Corp.
  
- David A. Harrison, Senior Director - Commercial Mortgage CDOs, Derivatives Fitch
  
- William C. Stefko, Esq., Partner, Alston & Bird
  
- Jan S. Sternin, CMB, Senior Vice President
- Midland Loan Services, Inc./PNC Real Estate Finance



# Building Blocks of CRE CDOs

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**Darren J. Esser, *Vice President***

**Wachovia Securities**

**February 5, 2007**



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# Differences: CDO vs. CMBS

## CDO

1. Issuer: Cayman Island Trust
2. Able to hold non-mortgage assets:
  - Unsecured debt (e.g. REIT debt)
  - Mezz, Preferred equity
  - Derivatives (e.g. swaps, caps, CDS)
  - Real Estate Operating Company (REOC) Debt (secured or unsecured)
3. Structure can issue any bond class as fixed or floating
4. First, second or multiple re-securitisation of assets
5. Able to fund future advances
6. Ability to manage assets (e.g. static vs. managed, mixed sector, ability to take views on credit), may or may not be fully ramped at closing
7. Call Optionality
8. Collateral Quality Tests (if managed)

## CMBS

1. Issuer: Real Estate Mortgage Investment Conduit (REMIC)
2. Trusts required to hold only mortgage loans:
  - No unsecured debt
  - No derivatives contracts
3. Generally issues debt of similar basis as assets (external balance guarantee swap, mostly on AAA)
4. First securitisation of assets
5. Not capable of funding future advances
6. Static loan pools, 100% ramped at closing, no ability to manage the pool
7. No call optionality (except % clean up call)
8. No CQTs

## Differences: CDO vs. CMBS continued

### CDO

9. Excess spread goes to equity
10. Structural protections:
  - Subordination
  - OC and IC Triggers (no principal write-downs; P&I become fungible)
  - Collateral Quality Tests
11. Offers ongoing management fees
12. Global buyer base
13. First loss class:
  - Excess cash flow class
  - No principal write-downs
  - Cash flow can turn on, off and on
14. Controlling Class: Senior most class
15. Motivations: Mostly financing, occasionally AUM
16. Servicing: Typically retained

### CMBS

9. Excess spread sold as Interest Only (IO) bond
10. Structural protections:
  - Only Subordination (principal write-downs; P&I have discrete waterfalls)
11. No ongoing management fees
12. Primarily U.S. buyer base (fixed rate)
13. First loss class:
  - Fixed coupon
  - Principal write-downs via:
    - Appraisal reductions, Realized losses
    - Cash flow terminates upon 100% write-down
14. Controlling Class: Junior most class (B-piece buyer)
15. Motivations: Most frequently arbitrage
16. Servicing: typically sold

# Issuer Motivation/Benefits

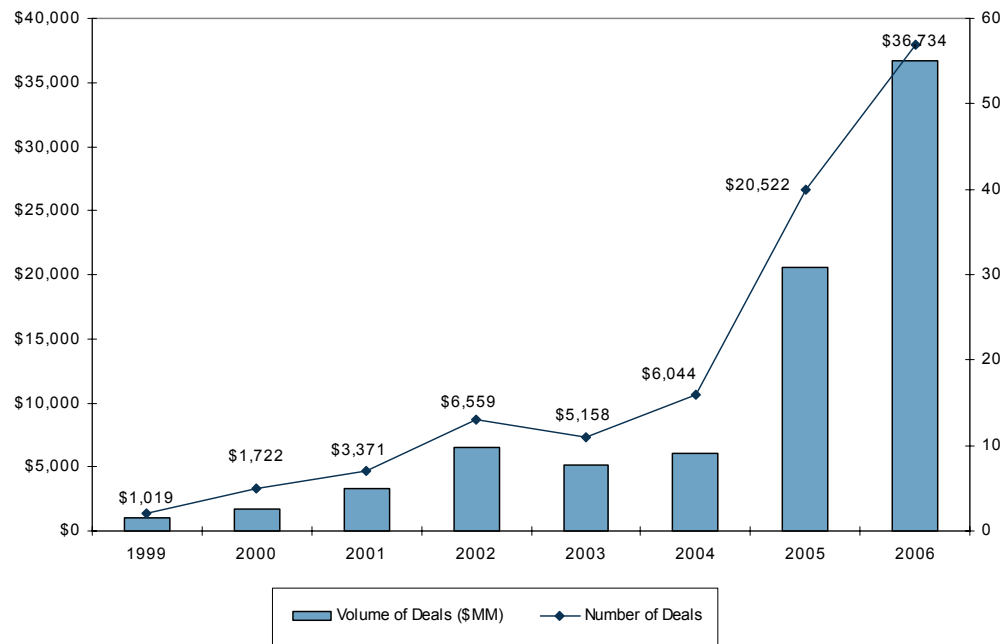
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- I. **Longer Financing Tenor:** Provides match-term funding for up to 10 years vs. typical repo term of 1-3 years
- II. **No Mark-to-Market risk:**
  - Significant advantage during volatile credit markets (e.g. Fall of 1998 Criimi Mae bankruptcy)
  - Financing structure is based primarily upon underlying asset credit performance
- III. **Cheaper cost of funds** vs. traditional repo lines
- IV. **Comparable advance rates** vs. traditional repo lines; however
- V. **Non-recourse Financing**
- VI. **Collateral Manager Flexibility:**
  - Reinvest collateral for up to 5 years
  - Provides efficient financing for short duration assets, such as floating rate CMBS, whole loans, B-notes, Mezz loans, etc., as well as longer term fixed rate asset
  - Callable typically after 3 years
  - Up to 10 year term
- VII. **Assets Under Management and Management Fees**
  - Allows for expansion of Assets Under Management
  - Provides Annuity Collateral Manager Fee Stream
- VIII. **Branding Benefits:** establishes sponsor as a capital markets collateral manager (creates franchise awareness/value)

# Historical CRE CDO Issuance

- Exceptional Growth in 2006:
  - 84.3% growth by volume
  - 40.0% growth by deal count
- 2005 production was equivalent to 86.0% of all previous existing deals

## Annual Volume

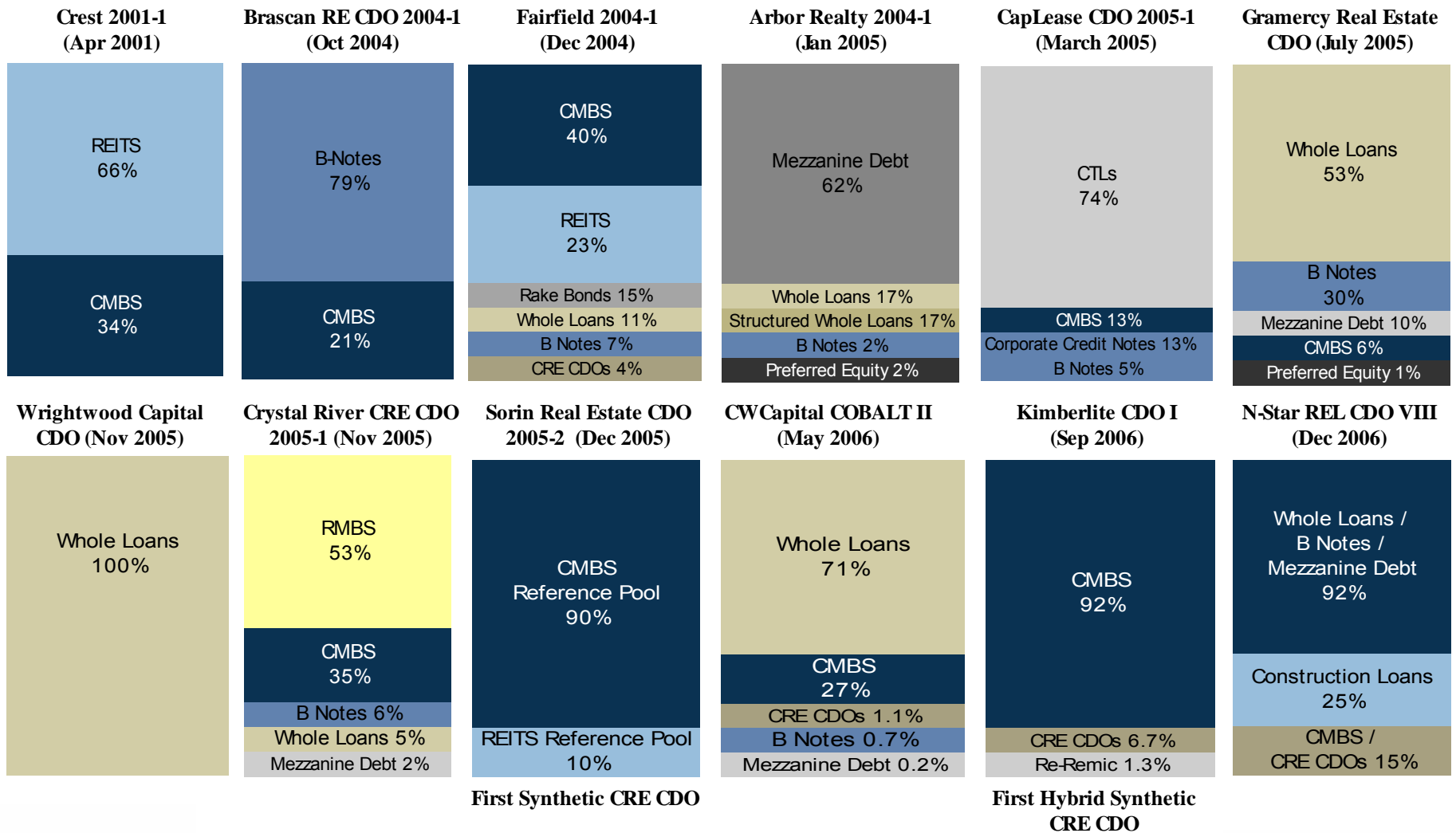


# Types of Collateral

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- CUSIP Collateral (Cash & Synthetic):
  - CMBS
  - REIT Debt
  - CRE CDO
- Commercial Real Estate Loans (Cash, Synthetic rare but coming):
  - Whole loans
    - » Transitional
    - » Development
  - CTL Loans
  - Bank loans to Real Estate Operators & Retailers secured by RE
  - B Notes
  - Mezzanine Debt
  - Preferred Equity
  - REIT Trust Preferred

# Collateral Evolution in the US: from 1 size fits all (static CMBS+REIT) to highly flexible financing vehicles



# Typical CRE CDO Issuer Execution

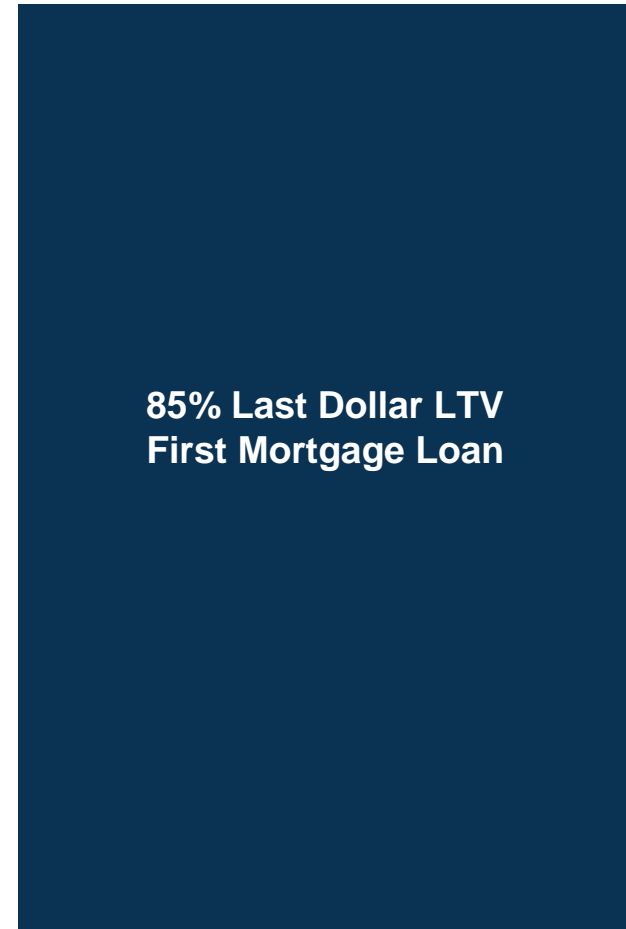
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## CMBS Conduit Financing



*B-note Mezz Sold Separately*

## CDO Financing



*Whole Loan Included in a Single Transaction*

# Static vs. Managed CRE CDOs

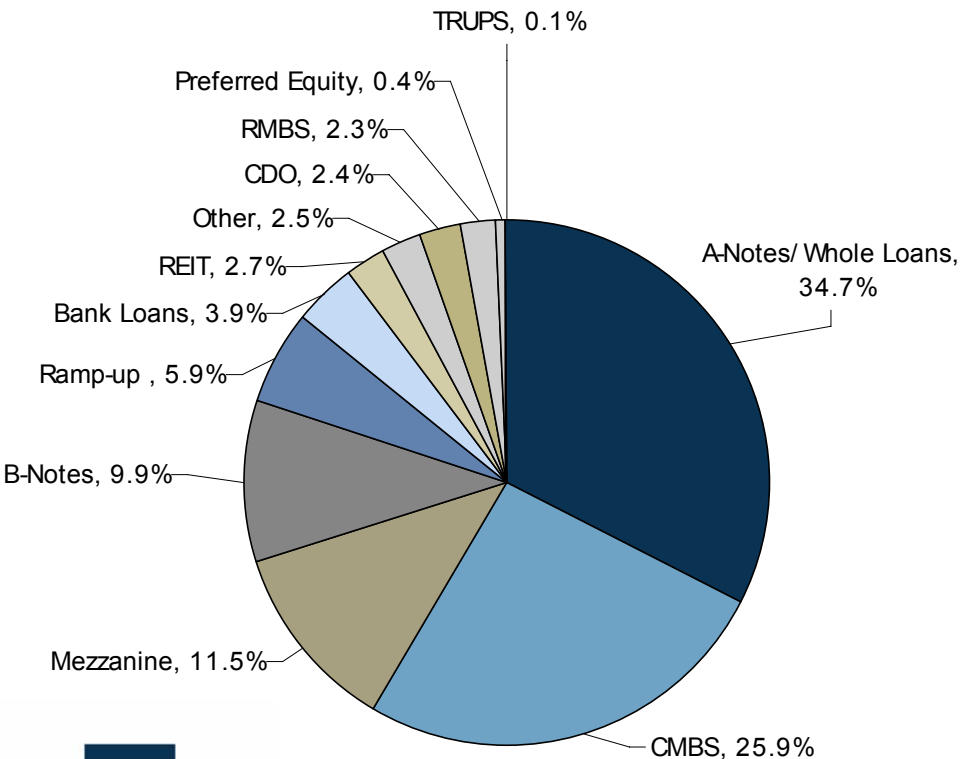
	Static	Managed
<b>Collateral Type:</b>	Fixed Rate	Fixed and/or Floating Rate
<b>Commercial Real Estate Sectors:</b>	CMBS Conduit REIT Whole Loan - Fixed CRE CDOs CTL B-Notes - Fixed Rake Bonds - Fixed	CMBS Conduit REIT REIT Trups Whole Loan- Fixed or Floating CMBS Large Loan Floaters CRE CDOs CTL B-Notes - Fixed or Floating Rake Bonds - Fixed or Floating Mezzanine Loans Preferred Equity
<b>Reinvestment of Returned Principal:</b>	None	5 years
<b>Collateral Quality Test (CQTs):</b>	None	Yes
<b>Balance Sheet Management:</b>	Repay liabilities only (straight sequential)	Reinvestment Period, either: a) Reinvest in new assets subject to CQTs b) Repay liabilities pro-rata c) Revolving bond class
<b>Sale of Collateral:</b>	Credit Risk Defaulted	Credit Risk Defaulted Credit Improved / Spread Appreciated Discretionary (10% per year)
<b>Advancing Agent:</b>	Yes, on Non-Pikable Classes if short falls on non - cusip assets	Yes, Non-Pikable Classes if short falls on non - cusip assets
<b>Collateral Manager Fees:</b>	Senior Fee: 10 bps Junior Fee: 10 bps	Senior Fee: 10 -20 bps Junior Fee: 15 -25 bps
<b>Manager Involvement:</b>	Surveillance, Loss Mitigation	Surveillance, Loss Mitigation, Pool Management

# Static vs. Managed CRE CDOs – Deal Composition

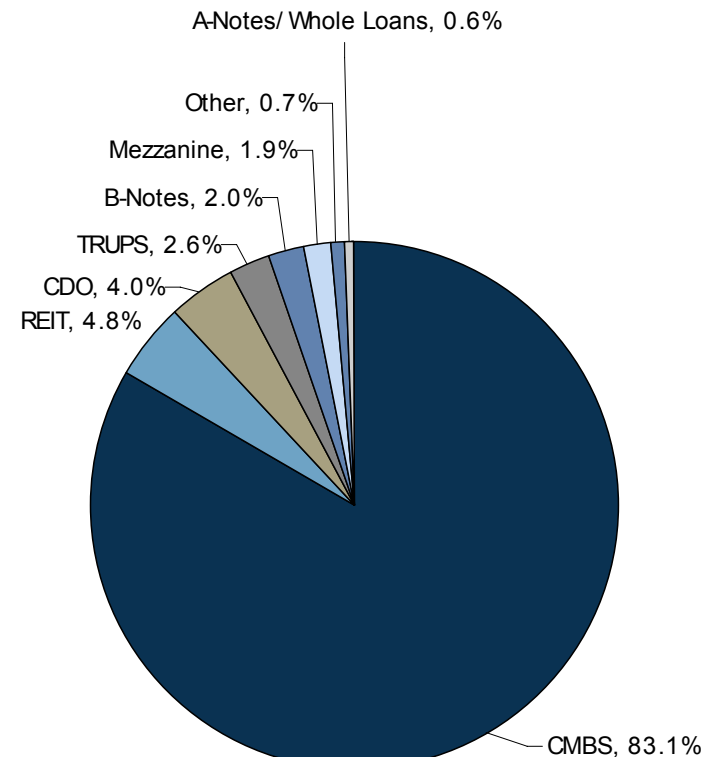
## Composition of Static vs. Managed CDOs

- Managed deals are mostly comprised of Whole Loans, A-Notes, and CMBS
- Static deals are mostly comprised of CMBS, CMBS CDS, CDOs, TRUPS

### Composition of Managed Deals in 2006



### Composition of Static Deals in 2006



# Hypothetical Whole Loan CRE CDO

Hypothetical Portfolio Characteristics:	
Portfolio Size (par)	\$1,000,000,000
HERF:	35
Portfolio WAS	325
WARF	3000

Basic CQTs:	
Reinvestment Period	5
Min WAS Covenant	200
Max WARF	3250

Reinvestment Assumptions:	
First 6 Months	275
Months 6 to 12	250
Months 12 to 18	225
Months 24 to 60	200

Ongoing Fee Assumptions:	
Senior Management:	[0.15000%]
Sub Management:	[0.25000%]
Trustee:	[0.01000%]
Advancing (on 'AAA' & 'AA'):	[0.07125%]
Administrative:	[0.05000%]

Indicative Capital Structure							
Tranche / Class	Par Size (\$MM)	Par %	C/E %	Spread	Rating	PIK	WAL
A1	[675.00]	[67.50%]	[32.50%]	L+[0.26%]	[AAA]	[Non-PIK]	[5.98]
A2	[75.00]	[7.50%]	[25.00%]	L+[0.30%]	[AAA]	[Non-PIK]	[7.10]
B	[41.00]	[4.10%]	[20.90%]	L+[0.37%]	[AA]	[Non-PIK]	[7.25]
C	[30.00]	[3.00%]	[17.90%]	L+[0.52%]	[A+]	[PIK]	[7.28]
D	[9.50]	[0.95%]	[16.95%]	L+[0.56%]	[A]	[PIK]	[7.50]
E	[10.50]	[1.05%]	[15.90%]	L+[0.70%]	[A-]	[PIK]	[7.50]
F	[19.00]	[1.90%]	[14.00%]	L+[1.00%]	[BBB+]	[PIK]	[7.50]
G	[13.00]	[1.30%]	[12.70%]	L+[1.20%]	[BBB]	[PIK]	[7.50]
H	[27.00]	[2.70%]	[10.00%]	L+[1.50%]	[BBB-]	[PIK]	[7.50]
Preferred Shares	[100.00]	[10.00%]					
	[1,000.00]	[100.00%]					

Equity IRR w/o Mgmt Fees:	[17.50%]
Equity IRR with Mgmt Fees:	[22.00%]

## Overcollateralization Ratios

Class	Covenant	As of Closing	Cushion
A/B	115.4%	126.4%	11.0%
C/D/E	110.9%	118.9%	8.0%
F/G/H	106.1%	111.1%	5.0%

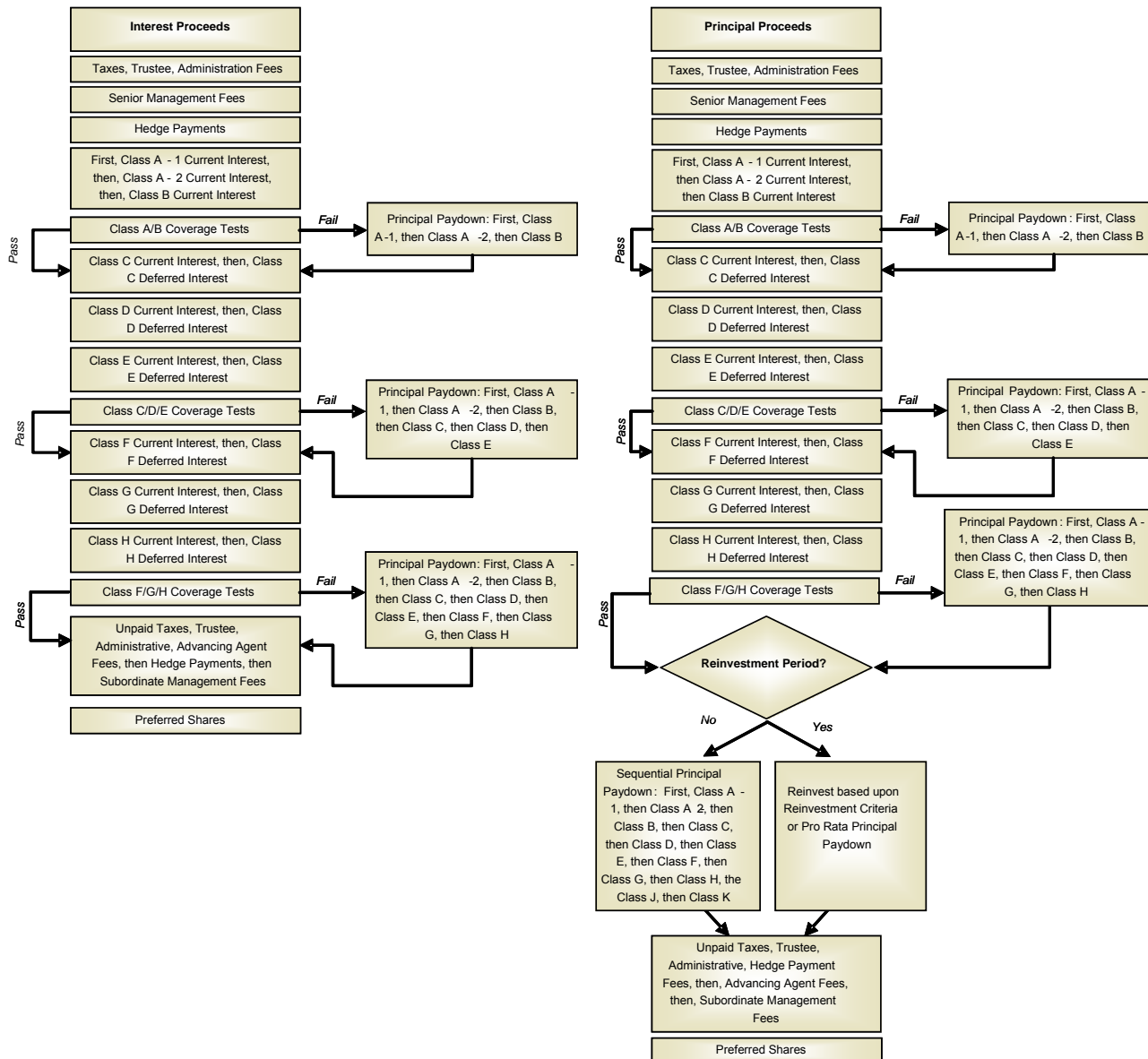
## Interest Coverage Ratios

Class	Covenant	As of Closing	Cushion
A/B	148.2%	193.4%	45.1%
C/D/E	138.8%	181.3%	42.5%
F/G/H	128.4%	167.2%	38.8%

# Collateral Quality Tests (CQTs):

CQT Parameter	Limit (Min./Max.)	Based on Fully Ramped Portfolio	Ramped Cushion
<b>Max. Geographic Distributions</b>			
California	[55.0]%	[22.0]%	[33.0]%
New York	[50.0]%	[15.0]%	[35.0]%
Florida	[40.0]%	[8.0]%	[32.0]%
Colorado	[30.0]%	[7.0]%	[23.0]%
Texas	[30.0]%	[5.0]%	[25.0]%
District of Columbia	[25.0]%	[11.0]%	[14.0]%
<b>Max. Property Concentrations</b>			
Office	[50.0]%	[35.0]%	[15.0]%
Multifamily	[40.0]%	[17.0]%	[23.0]%
Retail	[40.0]%	[15.0]%	[25.0]%
Hospitality	[30.0]%	[10.0]%	[20.0]%
Industrial	[25.0]%	[8.0]%	[17.0]%
Healthcare	[15.0]%	[5.0]%	[10.0]%
Condominium Conversion	[15.0]%	[5.0]%	[10.0]%
Land	[10.0]%	[0.0]%	[10.0]%
Single Property Type	[20.0]%	[5.0]%	[15.0]%
Max. CMBS/REIT	[15.0]%	[0.0]%	[15.0]%
Max. CRE CDO	[2.0]%	[0.0]%	[2.0]%
Max. Tranching WARF	[3250]	[3000]	[250]
Min. Weighted Average Fixed Rate Coupon	[7.0]%	[10.0]%	[3.0]%
Min. Weighted Average Floating Rate Spread over LIBOR	[2.00]%	[3.25]%	[1.25]%
Min. Herfindahl Diversity Test	[33.0]	[35.0]	[2.0]
Max. Obligor Concentration	[10.0]%	[8.5]%	[1.5]%
Max. Weighted Average Extended Maturity Test (Years)	[5.00]	[3.20]	[1.80]
Max. Fixed Rate Assets (unhedged)	[5.0]%	[1.5]%	[3.5]%

# US CRE CDO Cashflow Waterfall



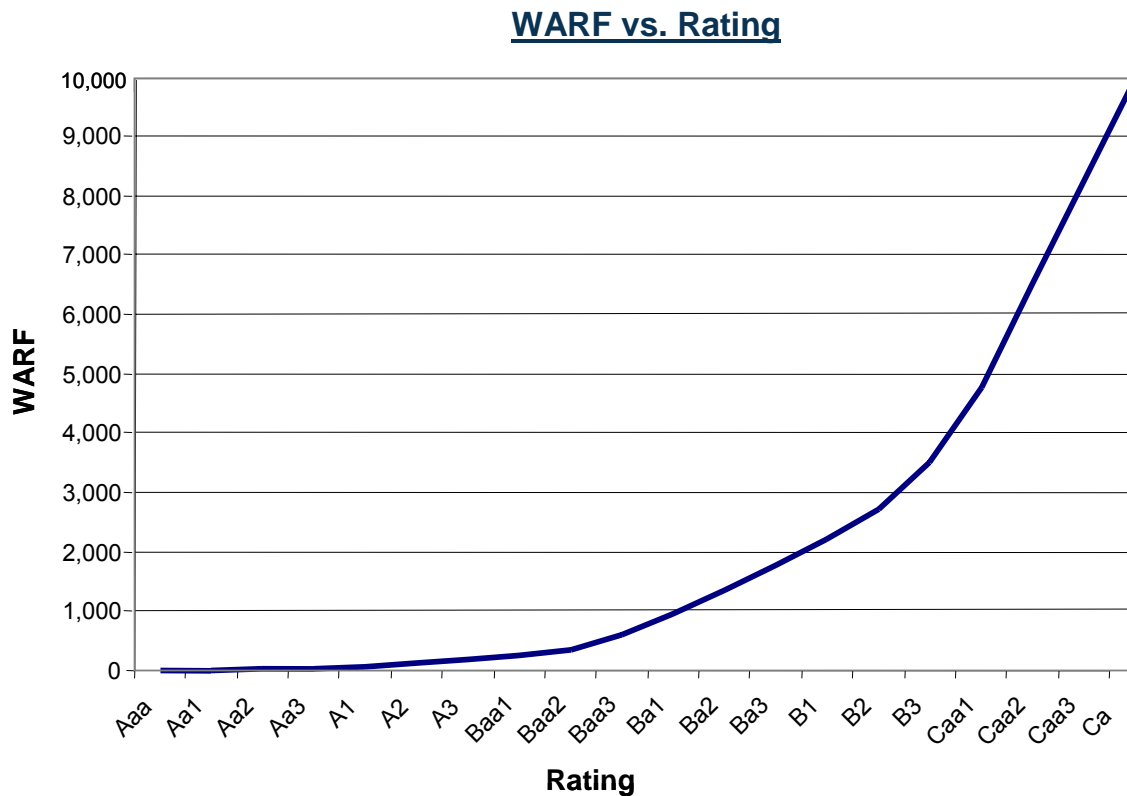
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# Appendices

# Appendix: Understanding WARF

- Moody's WARF – Weighted Average Rating Factor

Rating	Moody's 10-Year ICDR	WARF
Aaa	0.01%	1
Aa1	0.10%	10
Aa2	0.20%	20
Aa3	0.40%	40
A1	0.70%	70
A2	1.20%	120
A3	1.80%	180
Baa1	2.60%	260
Baa2	3.60%	360
Baa3	6.10%	610
Ba1	9.40%	940
Ba2	13.50%	1,350
Ba3	17.66%	1,766
B1	22.20%	2,220
B2	27.20%	2,720
B3	34.90%	3,490
Caa1	47.70%	4,770
Caa2	65.00%	6,500
Caa3	80.70%	8,070
Ca or lower	100.00%	10,000



## Appendix: Understanding H-Score

- Moody's Herfindhal Score

Measure of Pool diversity (higher is more diverse)

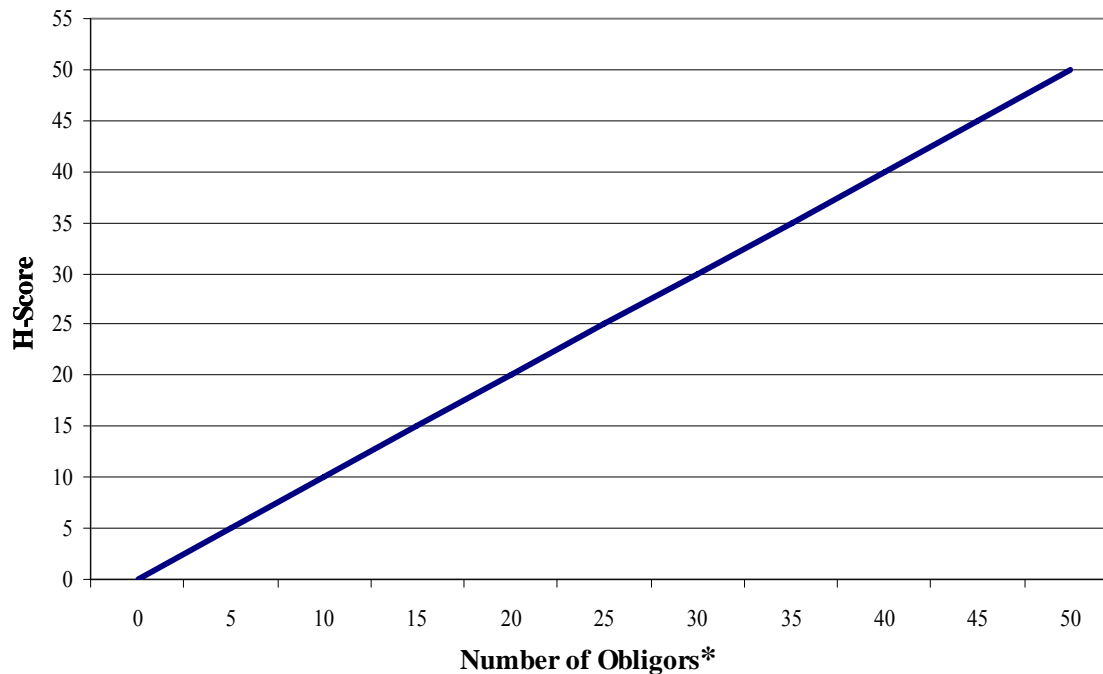
**H-Score =**

$$\frac{1}{\sum_{i=1}^N \left[ \frac{PB_i}{\text{Portfolio Balance}} \right]^2}$$

N = Number of Underlying Assets

PB<sub>i</sub> = Par Balance of the i<sup>th</sup> Asset

H-Score vs. Number of Obligor\*



Source: Moody's Investor Services

\*Linear relationship assumes equal par balances of the underlying CDO asset pool.

## Appendix: Relative Value Analysis

	<u>12/31/2000</u>	<u>12/31/2001</u>	<u>12/31/2002</u>	<u>12/31/2003</u>	<u>12/31/2004</u>	<u>12/31/2005</u>	<u>12/31/2006</u>
<b>CMBS Fixed Rate:</b>							
AAA 10 Yr.	42	55	48	30	26	30	25
A-	87	112	84	56	50	69	52
BBB	130	140	135	90	85	120	75
<b>CMBS LL Floaters:</b>							
AAA (senior)	NAV	55	35	22	15	16	10
A-	NAV	150	120	95	52	50	37
BBB	NAV	225	250	180	130	115	70
<b>REIT BBB (Spreads to Swaps):</b>	<b>123</b>	<b>117</b>	<b>144</b>	<b>59</b>	<b>62</b>	<b>71</b>	<b>45</b>
<b>CRE CDO:</b>							
AAA	48	49	57	48	34	36	30
A-	110	135	190	125	80	100	80
BBB	NAV	350	245	215	155	200	140
<b>CRE CDO vs. CMBS Fixed:</b>							
AAA	6	-6	9	18	8	6	5
A-	23	23	106	69	30	31	28
BBB	NAV	210	110	125	70	80	65
<b>CRE CDO vs. CMBS Floating:</b>							
AAA	NAV	-6	22	26	19	20	20
A-	NAV	-15	70	30	28	50	43
BBB	NAV	125	-5	35	25	85	70
<b>CRE CDO BBB vs. REIT</b>	<b>NAV</b>	<b>233</b>	<b>101</b>	<b>156</b>	<b>93</b>	<b>129</b>	<b>95</b>

## Appendix: Key Definitions

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- Interest Coverage

- Similar to debt service coverage
- Payment period measurement of net interest proceeds from the CDO asset pool to cover interest owed on particular liability tranches (cumulatively)

$$IC = \frac{\sum \begin{array}{l} \text{Scheduled interest payments on (1) the Collateral Securities (excluding Defaulted} \\ \text{Securities) and (2) Eligible Investments in the Collection Accounts} \\ + \text{ Fees received that constitute interest proceeds} \\ + \text{ Hedge receipt amount (plus if SWAP Counterparty pays; minus if Issuer pays)} \\ - \text{ Capped fees and expenses and senior collateral management fee in Interest} \\ \text{Waterfall} \end{array}}{\sum \begin{array}{l} \text{Scheduled period interest on } \mathbf{\text{Class A Notes}} \text{ and } \mathbf{\text{Class B Notes}} \\ + \text{ Any } \mathbf{\text{Class A}} \text{ and } \mathbf{\text{Class B}} \text{ defaulted Interest Amount.} \end{array}}$$

## Appendix: Key Definitions

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- Over collateralization (OC)
  - Similar to a LTV calculation that measures the par value of assets to cover the par amount of particular Liability Tranches (cumulatively)

$$OC = \frac{\sum \begin{array}{l} \text{The Aggregate Principal Balance (net of any writedowns) of} \\ \text{the Collateral Debt Securities} \\ + \text{Principal Proceeds held as Cash and Eligible Investments} \\ + \text{For Defaulted Securities the lesser of Market Value and} \\ \text{applicable Recovery Rate Value} \end{array}}{\sum \begin{array}{l} \text{The outstanding Principal Amount of the Class A and} \\ \text{Class B notes} \\ + \text{Any un-reimbursed Interest Advances} \end{array}}$$

# Appendix: Key Definitions

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## Collateral Debt Securities

- What assets can the CDO purchase both on the closing date and during the reinvestment period?
- If you are buying a CRE CDO do you want the collateral manager to have the ability to buy RMBS or corporate loans?
  - What's their expertise with these assets? to originate, manage, service, workout?
  - Are they searching for yield?

## Interest Proceeds and Principal Proceeds

- Determines how cash received on the Collateral Securities is applied.
- Interest Proceeds are used to pay the rated debt with excess Interest Proceeds distributed to the owner of the CDO Equity.
- Principal Proceeds are used during the reinvestment period to purchase additional assets for the CDO (or paydown Pro Rata).
- After the reinvestment period, Principal Proceeds are used to sequentially amortize the rated notes

## Interest Proceeds

- With respect to any payment date without duplication
  - All cash payments of interest on Collateral Debt Securities (other than Defaulted Securities);
  - All accrued interest received in cash on Collateral Securities sold;
  - All cash payments of interest on Eligible Investments purchased with amounts in the Interest and Principal Collection Accounts;
  - All cash payments of principal and interest on Eligible Investments purchased with amounts in the Interest Collection Account;
  - All net payments from hedge agreements (other than termination or notional reduction payments)

# Appendix: Key Definitions

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## Principal Proceeds

- With respect to any payment date without duplication
  - All principal payments received in cash on Collateral Debt Securities and Eligible Investments (other than Eligible Investments purchased with Interest Proceeds), including prepayment and yield maintenance payments or recoveries or other payments from the sale of Defaulted Securities
  - Sale Proceeds (Include Trading Gains?)
  - All cash payments of principal on Eligible Investments purchased with amounts in the Principal Collection Account
  - All amendment, waiver, late payment fees and other fees and commissions received in connection with the Defaulted Securities
  - Hedge termination or reduction proceeds (net of costs of replacement hedge and deferred premium payments); and
  - All other payments received w/r/t Collateral Debt Securities and Eligible Investments that are not included in Interest Proceeds

## Defaulted Security

- Any collateral debt security as to which:
  - There has occurred and is continuing a default as to the payment of the principal and/or interest;
  - Any bankruptcy or insolvency or receivership proceeding that has been initiated in connection with the issuer of such collateral;
  - Carries a defaulted rating from Moody's, S&P, or Fitch; and
  - The issuer is in default as to payment of principal and/or interest on another obligation which is senior or pari passu to such Collateral Security

# Appendix: Key Definitions

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## Spread Appreciated Asset

- Any Collateral Debt Security that has experienced an increase in its spread to its purchased spread over the asset's applicable benchmark since the date on which such asset was acquired, as substantiated by at least one (1) bid from a dealer independent from the Collateral Manager.

## Credit Risk Security

- Any Collateral Debt Security that, in the Collateral Manager's reasonable business judgment, (a) has a significant risk of declining in credit quality or with the lapse of time, becoming a Defaulted Security, (b) downgrade or downgrade watch by any of the Rating Agencies, (c) spread widening concept

## Advancing Agent

- Is required to make interest advances (subject to recoverability), in respect of interest shortfalls on the Non-Cusiped Collateral (e.g., B-Notes, Whole Loans) only to the extent Interest Proceeds (and, if applicable, Principal Proceeds) collected are insufficient to pay in full interest due on the non-pikable classes and to the extent such shortfall results from interest shortfalls on the Non-Cusiped Collateral

## Collateral Manager

- For Cause
  - Typically based upon a super-majority (66  $\frac{2}{3}$  - 75% ) of each class of notes, each voting as a separate class, (excluding any notes owned by the collateral manager) and a majority of the Preferred Shares
  - Upon the failure of the senior most OC test, based upon a majority of the controlling class
  - Automatic upon bankruptcy or insolvency of the collateral manager
- Without Cause
  - Typically based upon a super-majority of each class, each voting as a separate class, and 100% of the preferred shares

# Appendix: Key Definitions

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## Optional Redemption

- Typically 3 – 5 year non-call period
- Thereafter, Callable in whole but not in part
- Call Option owned by a majority Preferred Shares or at the direction of the Collateral Manager unless the holders of at least a majority of the aggregate outstanding notional amount of the Preferred Shares object

## Auction Call Redemption

- Typically starts in Yr. 10
- Redeemed in whole, not in part
- Redemption price = Par + Accrued + Expenses + any Swap Cancellation Fees

# Appendix: Key Definitions

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## CDO Events of Default

- Default for 3 Business Days in the payment of interest on any of the Non-pikable Notes, or the most senior class outstanding if the non-pikable classes have been repaid, so long as the more senior class (or classes) of Notes is not outstanding
- Default in the payment of principal (including capitalized interest) when due and payable at its Stated Maturity or Redemption Date on any of the outstanding Notes each so long as the more senior class (or classes) of Notes is not outstanding
- Default for 2 Business Days or more in the payment of any amount due and payable on any Payment Date when funds are available for payment
- Designation of Co-Issuers or Collateral as an investment company under the Investment Company Act of 1940
- Default in the performance or breach of any covenant, warranty or other agreement of the Co-Issuers under the Indenture, or failure of any representation or warranty of the Co-Issuers made under the Indenture or any certificate or other writing pursuant to the Indenture and continuation of such default for 30 days after the actual knowledge of such default or notice by at least 25% of the Controlling Class of Notes of such default to the Issuer, Collateral Administrator and/or Trustee
- Filing of voluntary or involuntary bankruptcy proceedings by or against the Co-Issuers

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