



COMPANY UPDATE / ESTIMATE CHANGE
TARGET CHANGE

Key Metrics

VMW - NYSE - as of	6/2/17	\$95.36
Price Target		\$107.00
52-Week Range	\$55.12 -	\$ 98.00
Diluted Shares Outstanding (000's)		406,698
Market Cap. (\$000's)		\$38,782,739
1-Mo. Average Daily Volume (000's)		1,457
Institutional Ownership (%)		22
Debt/Total Capital (net) % Q1'18		0
ROE %		15
Book Value / Share		\$19.75
Price / Book Value		4.8x
Indicated Dividend / Yield	\$0.00	0.0%
Current EBITDA Margin %		25.70

EPS FY 2/2

		Prior	Current		Prior	Current
	2016A	2018E	2018E*	A	2019E	2019E
1Q	\$0.86	\$0.97	\$0.99	A	\$1.04	\$1.06
2Q	\$0.97	\$1.09	\$1.12		\$1.19	\$1.25
3Q	\$1.14	\$1.27	\$1.24		\$1.37	\$1.36
4Q	\$1.43	\$1.57	\$1.55		\$1.69	\$1.69
Year	\$4.40	\$4.89	\$4.91		\$5.28	\$5.35
P/E	21.7x		19.4x			17.8x

*Note fiscal year '17 changes to Dell FYE '18

Revenue (\$mil)

		Prior	Current		Prior	Current
	2016A	2018E	2018E*	A	2019E	2019E
1Q	\$1,589	\$1,718	\$1,736	A	\$1,814	\$1,833
2Q	\$1,693	\$1,805	\$1,805		\$1,928	\$1,970
3Q	\$1,778	\$1,899	\$1,899		\$2,021	\$2,021
4Q	\$2,032	\$2,153	\$2,153		\$2,285	\$2,285
Year	\$7,092	\$7,576	\$7,576		\$8,050	\$8,111

Company Description: Palo Alto, CA based-VMware Inc. is the global leader in virtualization and cloud infrastructure solutions. VMware products include three key growth areas including, (SDDC) Software-Defined-Data-Center, (EUC) End-user Computing, & the Hybrid Cloud. License revenues constitute 36% of total revenue, while service revenue which includes software maintenance and professional services revenue represent 64% of total revenue.

Technology

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VMware Inc.

VMW - NYSE – Long-term Buy - 3

Strong Q1'18 Results, Raising FY'18 Outlook & PT to \$107

- Results.** VMware reported non-GAAP EPS of \$0.99 vs \$0.86 reported in the year ago period, an increase of 15%. This beat our view of \$0.97 and the consensus analyst estimate of \$0.95. Non-GAAP revenue totaled \$1.74 billion, increasing 9% y/y its fastest pace since 2015. License revenues increased 6.6%, to \$610 million, above the \$608 million consensus estimate but below our \$614.9 million view. Service revenue increased 11% y/y to \$1.126 billion, well ahead of our \$1.103 billion view. Operating income totaled \$495 million, up 11% y/y as operating margin expanded 40 bps y/y. Net income totaled \$411.8 million, an increase of 12.5% y/y. VMware has \$7.1 billion of net cash on its balance sheet or \$17.18 per share. Operating cash flow was \$775 million vs. \$720 million last year, while free cash flow was \$726 million vs. \$679 million. The company repurchased \$425 million of common stock in Q1 and has \$900 million remaining on the repurchase allotment.
- Product Highlights.** Total bookings increased 12% y/y when excluding the sale of vCloud Air, while licensing bookings increased 10%. NSX license bookings grew a strong 50% y/y, while vSAN license bookings increased 150% y/y. Six deals were over \$10 million vs. one in the year ago quarter.
- Outlook.** Management provided an improved FQ2'18 outlook including EPS of \$1.11 to \$1.14 on revenue of \$1.84 billion to \$1.89 billion. This is above our prior EPS view of \$1.09 on revenue of \$1.805 billion. Management's full year fiscal 2018 outlook was also raised with revenue expected of \$7.61 billion and EPS of \$4.91 vs. our prior view of \$7.576 billion & EPS of \$4.89 view. We believe mid-year availability of VMware Cloud on AWS and Cross-Cloud Services will boost results going forward despite more difficult comparisons in the second half of the year.
- Valuation & Opinion.** We maintain our Long-term Buy rating. Our price target increases to \$107 from \$105. We achieve our price target by multiplying our FYE'19 EPS estimate of \$5.35 by 20x (in line with our prior forward P/E multiple and the current forward multiple) on better than expected results and an improved outlook. Despite better than expected Q1 results and Q2 guidance, our 2H'18 outlook has been adjusted lower.

Note Important Disclosures on Pages 6-7
Note Analyst Certification on Page 6

ADDITIONAL DISCUSSION

VMware shifted to Dell's fiscal year end 2/2. The company's 10-Q will highlight stub period performance when released. Initially, the company reported revenue of \$496 million vs. \$482 million last year. We view the stub period performance as normal including lower seasonal revenue growth and higher cash flow generation.

Unearned revenue of \$5.235 billion increased 5.2% y/y, this was below the consensus target of \$5.530 billion, however this excludes \$35 million of unearned revenue from vCloud Air. The figure was also in line with growth in Q1 of last year. Enterprise license agreements were 32% of total bookings vs. 29% in Q1 of last year. Total bookings increased 12% y/y when excluding the sale of vCloud Air, while licensing bookings increased 10%. NSX customers increased to 2,600 from 2,400 last quarter, NSX license bookings increased a strong 50% y/y. vSAN customers topped 8,000, up from 7,000 last quarter, while vSAN license bookings increased 150% y/y. Total compute bookings and compute license bookings increased mid-single digits. End user computing license bookings increased over 20% y/y, a strong quarter of growth on strength from AirWatch.

In May, VMware announced it would sell vCloud Air to OVH Group and embark on a new strategy of partnering with large public cloud providers. As part of this new strategy, VMware recently announced its Cross Cloud Architecture for hybrid cloud deployments and recent large partnership deals with Google, Oracle, Microsoft, IBM and Amazon's AWS cloud service. We believe with these new partnerships as well as continued growth from hyper-converged infrastructure software including NSX, vSAN, and VxRail, give us confidence in VMware's new strategy of partnering with public cloud providers to help enterprises build/manage the best enterprise hybrid cloud environment. Customers implement hyper-converged infrastructure including NSX and vSAN for data center efficiency gains, security/encryption, app automation, and cross cloud services.

VALUATION

We maintain our Long-term Buy rating and increase our price target to \$107 from \$105 through our investment timeframe of FYE'19 (2/2/2019). We achieve our price target by multiplying our FYE'19 EPS estimate of \$5.35, an increase from \$5.28, by 20x, which is in line with our prior forward P/E multiple and the current forward multiple, on better than expected results and an improved outlook.

Despite our improved Q2 and full year outlook, we adjust our second half estimates slightly lower. We believe some of this concern led to recent share price weakness after the company's generally positive Q1 report.

We believe VMware's new partnerships with Microsoft and AWS, along with NSX and vSAN products and cross cloud services will boost growth offsetting maturing growth from vSphere. We believe our \$107 price target remains conservative as these opportunities could boost the multiple investors are willing to pay for VMware's growth. We also acknowledge the large cash position VMware has at its disposal which could be utilized to further boost buybacks and/or acquire additional growth opportunities.

SUITABILITY

We assign shares of VMW a suitability rating of 3 on our scale of 1-4 (1 = most conservative, 4 = most aggressive). A 3 rating is given based on VMware's high levels of competition within VMware's new end markets while the x86 server virtualization market is mature. We believe the company has a solid balance sheet and continues to generate significant free cash flow. VMware's unique ownership structure inside a larger Dell conglomerate has both positive and negative attributes. We believe a suitability rating of 3 incorporates VMware's risk profile. Shares of VMW are suitable for aggressive growth oriented investors seeking long-term capital appreciation, in our view.

RISKS & CONSIDERATIONS

Risks to our valuation include but are not limited to:

- Changes in macroeconomic conditions can affect global IT spending.
- Total revenue growth may slow as the compute virtualization market matures. A majority of workloads have been virtualized and, therefore, VMW now focuses on products and services for the platform-as-a-service and software-as-a-service markets. If these solutions are adopted more slowly or less broadly VMware growth may slow.
- Retaining key personnel and the integration of newly acquired businesses.
- Breach of security could impact the company for a significant period of time.
- Foreign currency effects as well as fluctuations in sales cycle and the lack of predictability of future revenues.
- Reliance on third party channel partners, as a majority of sales were from these sources.
- Dell's controlling stake gives VMware stakeholders limited rights which may have negative impacts to long-term goals.
- VMW shares may experience high levels of price volatility due to a small outstanding float.

VMware Inc. Non GAAP Income Statement (in \$000's except per share data)

	2009	2010	2011	2012	2013	2014	2015	2016	Stub Period	Q1'18	Q2'18E	Q3'18E	Q4'18E	2018E	2019E
Revenue:															
License	\$ 1,029,442	\$ 1,401,424	\$ 1,841,169	\$ 2,086,990	\$ 2,269,727	\$ 2,591,000	\$ 2,720,000	\$ 2,794,000		\$ 610,000	\$ 695,520	\$ 729,005	\$ 922,480	\$ 2,957,005	\$ 3,096,300
Services	994,495	\$ 1,455,919	\$ 1,925,927	2,518,057	2,936,839	3,444,000	3,928,000	4,298,000		1,126,000	1,148,655	1,170,699	1,230,875	4,676,229	5,015,052
Total Revenues	2,023,937	2,857,343	3,767,096	4,605,047	5,206,566	6,035,000	6,648,000	7,092,000		1,736,000	1,844,175	1,899,704	2,153,355	7,633,234	8,111,352
Operating expenses:															
Cost of license revenues	30,792	52,414	74,857	92,682	83,025	83,000	80,000	57,000		12,000	15,150	14,040	14,245	55,435	56,061
Cost of services revenues	217,720	292,318	384,865	450,644	489,016	679,000	784,000	839,000		233,000	228,735	232,140	243,090	936,965	995,614
Research and development	441,602	537,820	661,874	778,792	845,701	992,000	1,072,000	1,198,000		337,000	341,020	344,535	348,540	1,371,095	1,461,997
Sales and marketing	675,532	931,705	1,222,868	1,477,880	1,661,779	1,941,000	2,068,000	2,133,000		531,000	555,985	537,420	620,550	2,244,955	2,387,269
General and administrative	174,567	230,067	256,187	314,093	358,557	462,000	534,000	571,000		128,000	141,620	147,175	146,880	563,675	594,063
Operating income	483,724	813,019	1,169,445	1,490,956	1,768,488	1,878,000	2,110,000	2,294,000		495,000	561,665	624,394	780,050	2,461,109	2,616,349
Investment income	8,233	6,633	16,157	26,557	29,720	39,000	49,000	75,000		23,000	23,000	23,000	23,000	92,000	94,000
Interest expense with Dell, net	(6,958)	(4,069)	(3,906)	(4,654)	(3,865)	(26,000)	(27,000)	(28,000)		(7,000)	(7,000)	(7,000)	(7,000)	(28,000)	(14,000)
Other income, net	(2,980)	(14,182)	(9,009)	(732)	(1,874)	1,000	(5,000)	(2,000)		7,000	5,000	-	-	12,000	14,000
Income before income taxes	482,019	801,401	1,169,687	1,512,127	1,792,469	1,892,000	2,127,000	2,339,000		518,000	582,665	640,394	796,050	2,537,109	2,710,349
Income tax provision	80,989	162,494	233,936	276,538	331,322	349,000	398,000.00	478,000		106,190	119,446	131,281	163,190	520,107	555,621
Net income	\$ 401,030	\$ 638,907	\$ 935,751	\$ 1,235,589	\$ 1,461,147	\$ 1,543,000	\$ 1,729,000	\$ 1,861,000		\$ 411,810	\$ 463,219	\$ 509,113	\$ 632,860	\$ 2,017,002	\$ 2,154,727
Non GAAP basic EPS	\$ 1.02	\$ 1.56	\$ 2.22	\$ 2.90	\$ 3.40	\$ 3.59	\$ 4.08	\$ 4.43		\$ 1.01	\$ 1.14	\$ 1.26	\$ 1.57	\$ 4.97	\$ 5.40
Non GAAP diluted EPS	\$ 1.00	\$ 1.51	\$ 2.17	\$ 2.85	\$ 3.38	\$ 3.55	\$ 4.06	\$ 4.40		\$ 0.99	\$ 1.12	\$ 1.24	\$ 1.55	\$ 4.91	\$ 5.35
Basic shares outstanding	394,269	409,805	421,188	426,655	429,120	430,356	424,025	420,540		408,431	406,000	405,000	403,000	405,608	398,750
Diluted shares outstanding	399,776	423,446	431,750	433,588	432,813	434,063	426,033	423,201		414,018	412,000	410,000	408,000	411,005	403,000
Y/Y Growth Rate															
Total revenue	7.6%	41.2%	31.8%	22.2%	13.1%	15.9%	10.2%	6.7%		9.3%	8.9%	6.8%	6.0%	7.6%	6.3%
License revenue	-12.6%	36.1%	31.4%	13.4%	8.8%	14.2%	5.0%	2.7%		6.6%	8.0%	5.5%	4.0%	5.8%	4.7%
Service revenue	41.5%	46.4%	32.3%	30.7%	16.6%	17.3%	14.1%	9.4%		10.7%	9.5%	7.7%	7.5%	8.8%	7.2%
Cost of license revenue	27.8%	70.2%	42.8%	23.8%	-10.4%	0.0%	-3.6%	-28.8%		-20.0%	1.0%	8.0%	1.8%	-2.7%	1.1%
Cost of service revenue	7.7%	34.3%	31.7%	17.1%	8.5%	38.9%	15.5%	7.0%		17.7%	10.5%	9.5%	9.5%	11.7%	6.3%
R&D	2.1%	21.8%	23.1%	17.7%	8.6%	17.3%	8.1%	11.8%		17.8%	18.0%	11.5%	11.0%	14.4%	6.6%
S&M	12.7%	37.9%	31.3%	20.9%	12.4%	16.8%	6.5%	3.1%		4.5%	5.5%	6.0%	5.0%	5.2%	6.3%
G&A	13.5%	31.8%	11.4%	22.6%	14.2%	28.8%	15.6%	6.9%		-5.9%	-3.0%	1.5%	2.0%	-1.3%	5.4%
Operating income	3.2%	68.1%	43.5%	27.8%	18.6%	6.2%	12.4%	8.7%		11.0%	10.3%	5.5%	4.4%	7.3%	6.3%
Net income	-3.5%	59.3%	46.5%	32.0%	18.3%	5.6%	12.1%	7.6%		12.5%	11.9%	5.0%	6.0%	8.4%	6.8%
EPS	-4.1%	50.4%	43.6%	31.5%	18.5%	5.3%	14.2%	8.4%		15.3%	16.0%	8.8%	8.2%	11.6%	9.0%
Shares outstanding	0.7%	5.9%	2.0%	0.4%	-0.2%	0.3%	-1.8%	-0.7%		-2.4%	-3.5%	-3.5%	-2.0%	-2.9%	-1.9%
Percent of Revenue															
License revenue	50.9%	49.0%	48.9%	45.3%	43.6%	42.9%	40.9%	39.4%		35.1%	37.7%	38.4%	42.8%	38.7%	38.2%
Service revenue	49.1%	51.0%	51.1%	54.7%	56.4%	57.1%	59.1%	60.6%		64.9%	62.3%	61.6%	57.2%	61.3%	61.8%
Gross margin	87.7%	87.9%	87.8%	88.2%	89.0%	87.4%	87.0%	87.4%		85.9%	86.8%	87.0%	88.0%	87.0%	87.0%
R&D	21.8%	18.8%	17.6%	16.9%	16.2%	16.4%	16.1%	16.9%		19.4%	18.5%	18.1%	16.2%	18.0%	18.0%
S&M	33.4%	32.6%	32.5%	32.1%	31.9%	32.2%	31.1%	30.1%		30.6%	30.1%	28.3%	28.8%	29.4%	29.4%
G&A	8.6%	8.1%	6.8%	6.8%	6.9%	7.7%	8.0%	8.1%		7.4%	7.7%	7.7%	6.8%	7.4%	7.3%
Operating margin	23.9%	28.5%	31.0%	32.4%	34.0%	31.1%	31.7%	32.3%		28.5%	30.5%	32.9%	36.2%	32.2%	32.3%
Tax rate	16.8%	20.3%	20.0%	18.3%	18.5%	18.4%	18.7%	20.4%		20.5%	20.5%	20.5%	20.5%	20.5%	20.5%
Net profit margin	19.8%	22.4%	24.8%	26.8%	28.1%	25.6%	26.0%	26.2%		23.7%	25.1%	26.8%	29.4%	26.4%	26.6%

Source: Company data & Hilliard Lyons estimates. Note: We do not include transition period financials in our outlook and future y/y comparisons will not be a direct comparison.

VMware Inc. Balance Sheet (in \$000's)

Assets	2008	2009	2010	2011	2012	2013	2014	2015	Q1'16	Q2'16	Q3'16	Q4'16	2016	Q1'18
Cash and cash equivalents	\$ 1,840,812	\$ 2,486,461	\$ 1,628,965	\$ 1,955,756	\$ 1,609,322	\$ 2,305,000	\$ 2,071,000	\$ 2,493,000	\$ 2,785,000	\$ 2,991,000	\$ 2,654,000	\$ 2,790,000	\$ 2,790,000	\$ 3,864,000
Short-term investments	-	27,360	1,694,675	2,556,450	3,021,512	3,870,000	5,004,000	5,016,000	5,461,000	5,674,000	5,600,000	5,195,000	5,195,000	4,748,000
Accounts receivable, net	338,014	534,196	614,726	882,857	1,150,906	1,220,000	1,520,000	1,633,000	1,089,000	1,215,000	1,119,000	1,856,000	1,856,000	867,000
Due from Dell, net	-	26,402	55,481	73,799	67,934	-	49,000	74,000	12,000	96,000	23,000	132,000	132,000	127,000
Deferred tax asset	44,573	63,360	100,689	128,471	179,430	190,000	248,000	-	-	-	-	-	-	-
Other current asset	166,689	44,701	203,119	80,439	90,935	96,000	238,000	144,000	147,000	167,000	159,000	362,000	362,000	172,000
Total current assets	2,390,088	3,182,480	4,297,655	5,677,772	6,120,039	7,681,000	9,130,000	9,360,000	9,494,000	10,143,000	9,555,000	10,335,000	10,335,000	9,778,000
Property and equipment, net	418,212	402,356	419,065	525,490	664,669	845,000	1,035,000	1,128,000	1,108,000	1,073,000	1,050,000	1,049,000	1,049,000	993,000
Capitalized software costs, net	134,553	169,293	151,945	154,236	128,701	107,000	174,000	193,000	195,000	218,000	232,000	248,000	248,000	240,000
Deferred tax asset	68,280	102,529	149,126	156,855	103,001	60,000	165,000	456,000	464,000	442,000	462,000	462,000	462,000	724,000
Intangible assets, net	56,984	94,557	210,928	407,375	731,852	607,000	748,000	616,000	582,000	577,000	538,000	517,000	517,000	474,000
Goodwill	771,088	1,115,769	1,568,600	1,759,080	2,848,130	3,027,000	3,964,000	3,993,000	3,993,000	4,031,000	4,032,000	4,032,000	4,032,000	4,032,000
Total assets	3,839,205	5,066,984	6,797,319	8,680,808	10,596,392	12,327,000	15,216,000	15,746,000	15,836,000	16,484,000	15,869,000	16,643,000	16,643,000	16,241,000
Liabilities and Stockholders' Equity														
Accounts payable	74,708	50,566	58,913	49,747	89,562	109,000	203,000	138,000	106,000	115,000	104,000	125,000	125,000	116,000
Accrued expenses and other	260,687	334,523	459,813	587,650	674,746	626,000	811,000	746,000	622,000	735,000	649,000	898,000	898,000	897,000
Due to related parties	-	-	-	-	-	-	-	-	-	-	-	-	-	680,000
Unearned revenues	544,355	908,953	1,270,426	1,764,109	2,195,926	2,558,000	2,982,000	3,245,000	3,181,000	3,276,000	3,279,000	3,531,000	3,531,000	3,317,000
Total current liabilities	879,750	1,294,042	1,789,152	2,401,506	2,960,234	3,293,000	3,996,000	4,129,000	3,909,000	4,126,000	4,032,000	4,554,000	4,554,000	5,010,000
Note payable to Dell	450,000	450,000	450,000	450,000	450,000	450,000	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000	820,000
Unearned revenues	325,634	416,345	589,668	944,309	1,264,639	1,534,000	1,851,000	1,831,000	1,795,000	1,846,000	1,815,000	2,093,000	2,093,000	1,918,000
Deferred tax liability	47,825	60,300	30,096	-	-	-	-	-	-	-	-	-	-	-
Other liabilities	65,929	103,346	129,960	114,711	181,538	234,000	283,000	363,000	361,000	376,000	388,000	399,000	399,000	425,000
Total liabilities	1,769,138	2,324,033	2,988,876	3,910,526	4,856,411	5,511,000	7,630,000	7,823,000	7,565,000	7,848,000	7,735,000	8,546,000	8,546,000	8,173,000
Stockholders' Equity														
Total stockholders' equity	2,070,067	2,742,951	3,808,443	4,770,282	5,739,981	6,816,000	7,586,000	7,923,000	8,271,000	8,636,000	8,134,000	8,097,000	8,097,000	8,068,000
Total liabilities and stockholders' equity	3,839,205	5,066,984	6,797,319	8,680,808	10,596,392	12,327,000	15,216,000	15,746,000	15,836,000	16,484,000	15,869,000	16,643,000	16,643,000	16,241,000

Source: Company data

Other companies mentioned: Dell Technologies Inc. (DVMT-\$68.25), Amazon Inc. (AMZN-\$1006.73), and IBM (IBM-\$152.05), Microsoft (MSFT-\$71.76-Neutral), Alphabet (GOOGL-\$996.12-Neutral), and Oracle (ORCL-\$45.66).

Additional information is available upon request.

Analyst Certification

I, Stephen Turner, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Important Disclosures

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

The author of this report or members of his household have a long position in the common stock of VMware Inc., but may not engage in buying or selling contrary to the recommendation.

Suitability Ratings

1 - A large cap, core holding with a solid history

2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks

3 - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage

4 - Speculative, due to small size, inconsistent profitability, erratic revenues, volatility, low trading volume or a narrow customer or product base

Investment Ratings

Buy - We believe the stock has significant total return potential in the coming 12 months.

Long-term Buy - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.

Neutral - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.

Underperform - We believe the stock is vulnerable to a price setback in the next 12 months.



Rating	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
	# of Stocks Covered	% of Stocks Covered	Banking	No Banking
Buy	32	26%	13%	88%
Hold/Neutral	79	64%	8%	92%
Sell	12	10%	0%	100%

As of 8 May 2017

Other Disclosures

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