

IS MOLYBDENUM ANOTHER WAY TO RIDE THE ENERGY BULL?

The “Energy” Metal Is Used in Oil/Gas Pipelines, Drill Rigs, and Nuclear Power Plants

By James Finch

Earlier this month, a reporter from *Business Edge* (Ontario edition) was pondering investment advice he might receive over a fantasy lunch with different financial gurus, such as Warren Buffet, Jim Dines and Eric Sprott. He said of Eric Sprott, “You’d be hard pressed to find a savvier market player than Canadian money manager Eric Sprott - anywhere.” Because the reporter was appraising the dollar value of an auctioned “charity lunch” with an investment guru, he embellished upon his witticism, “This lunch could be worth a mint if Sprott were to let you in on the next big thing. In recent years, the CEO of Toronto-based Sprott Asset Management has been consistently ahead of the street.”

And what might this secret tip be? Perhaps molybdenum could become the next big thing. We talked with Maria Smirnova, a Sprott Asset Management Research Associate, who spoke positively of the metal, “I think the key to the molybdenum story is its wide-reaching applicability, especially in the energy sector.” She added, “This specialty metal is used in oil and natural gas pipelines, hydrocarbon desulphurization, oil drill rigs, pollution control equipment and nuclear energy applications.” Energy bulls, perhaps even the Sprott team which has bet heavily on the energy sector and invested in two molybdenum juniors, believe the world will need more “moly” during this commodities boom.



The petroleum industry depends upon molybdenum's complex and unique properties. Pipelines rely on moly's corrosive-resistance properties.

“It’s not sexy or glamorous,” Raymond James’ (Canada) uranium analyst Bart Jaworski told us during a telephone chat a few months ago, “and besides it’s dominated by the Chinese.” Well yes, that is true, but isn’t the uranium price also being driven higher by Chinese stockpiling? Another drawback for the metal, as Maria Smirnova, pointed out during a recent phone conversation, is that many can’t even pronounce ‘molybdenum.’ So, they call it ‘moly’ for short, as if this specialty metal belonged in the lyrics of Little Richard (Good Golly, Miss Molly).

According to the International Molybdenum Associations (IMOA), nearly 80 percent of the moly demand comes about for the manufacturing of tools, high speed steel, stainless steel and low alloy steel. Since World War I, moly has become a lower cost replacement for tungsten in hard and impact-resistant steels. It was first used as an alloying element in the production of armor plate.

Molybdenum commodity specialist Michael J. Magyar describes molybdenum’s properties and uses in the United States Geological Survey Minerals Yearbook, “Molybdenum is a refractory metallic element used principally as an alloying agent in cast iron, steel, and super alloys to enhance hardenability, strength, toughness, and wear- and corrosion-resistance. To achieve desired metallurgical properties, molybdenum ... is fre-



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Malaysia's Petronas Towers, the world's tallest buildings, use a popular form of stainless steel, with a three percent molybdenum content.

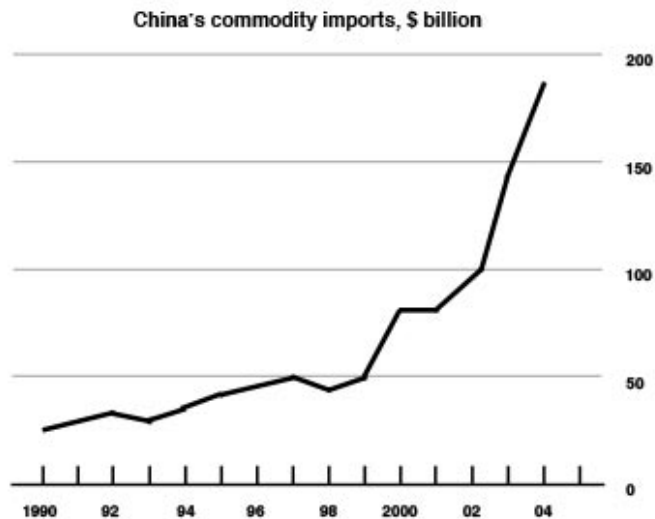
quently used in combination with or added to chromium, columbium, manganese, nickel, tungsten or other alloy metals."

Exploration for new sources of oil has led to the development of deep drilling. The very deep reservoirs are often contaminated with corrosive sulphides, brines and carbon dioxide. Moly is the most sulphide stress cracking resistance low alloy steel available for use in sour wells. As service conditions deteriorate, oil companies are turning to higher molybdenum stainless steels (with 13 - 16 percent moly content) to manage the unfavorable elements at those depths.

Sixty percent of molybdenum consumption is used for stainless steels, super alloys or lower alloy steel. An example is a popular form of stainless steel called S31600 (Type 316), containing three to four percent Moly. This type of stainless steel was used to clad the exterior of tallest building in the world - the Petronas Towers in Kuala Lumpur in Malaysia, London's Canary Wharf and in many other architectural applications in marine coastal environments.

According to the IMO, "The most corrosion resistant stainless steels contain 6 to 7.3 percent molybdenum. These grades are used for power plant condensers, offshore piping, and critical components in nuclear power plants such as service water piping. In 1996, 6 percent moly stainless steels were selected for the absorber towers of more than twenty flue gas desulphurization scrubbers being installed in coal-burning power plants in South Korea."

Molybdenum-based catalysts are growing. The oil industry has been using moly to remove sulphur from the compounds usually found in crude oil. As petroleum production turns to higher sulphur crude oil, they will require more molybdenum-based catalysts. Others plan to use moly in liquefying coal. True, this consumption remains early days. But, in early February,



China's appetite for commodities continues to soar.

China Oil News reported China plans to spend \$15 billion to build coal liquefaction plants in that country. China hopes to draw from its enormous coal deposits for conversion into oil products, using molybdenum-based catalysts.

China's Appetite for Molybdenum

More than 60 percent of molybdenum mined comes about as a byproduct of copper production. Many commodity investors see the rally in molybdenum prices as an afterthought, because copper has soared. In fact, molybdenum may have strong reasons to remain firm, or continue rising through the rest of this year and into 2007. On July 14th, an official at China's largest molybdenum producer, Jinduicheng Molybdenum Mining (JDC), told Platts news service in Hong Kong that China's demand would rise "at least 20 percent this year."

Maria Smirnova was not surprised by this, writing in an email to us, "Chinese industrial production grew at around 18 percent in the first half of 2006, so a 20 percent growth in moly demand is in line with this number." She added, "In my opinion China alone should not cause the price to spike because it represents only 11 percent of world consumption. So a 20 percent growth in China would add two percent or nine million pounds to the world demand." Smirnova believes we could see new production of that magnitude come onstream to satisfy the increased Chinese demand.

Some believed moly demand would increase after China announced that the country's GDP grew by nearly 11 percent in the first half of 2006, about eight percent faster than a year ago. While investors wonder whether China can continue growing at this pace, many Chinese officials aren't willing to let it slow down. Said Fan Jianping, China's deputy director of the Economic Prediction Department, told Xinhua news service on July 22nd, "It is not necessary for China to slam on the brakes with



A drill core showing a high grade of silvery gray molybdenum

all strength because the economy is not overheating to such an extent." He emphasized officials weren't worrying about the economic expansion, saying "There is no need to launch a comprehensive adjustment now."

Demand for molybdenum is rising in China, according to JDC. One reason is the use of moly in the production of steel pipelines. Our coalbed methane research with regards to China, when writing about Pacific Asia China Energy, highlighted why the country would continue requiring pipelines - they plan to increase their dependence upon natural gas to eight percent of the country's energy mix. More steel pipelines would mean more molybdenum. And JDC has no plans to mine more molybdenum this year than it did the year before. In 2005, China's top moly miner produced 24 million pounds, about six percent of the world's total production.

What about a Base Metals Correction?



How will pricing for molybdenum hold up, should base metal prices experience a downtrend?

International Stainless Steel Federation has forecast even faster 5.5 percent annual growth up to at least 2010. Increased production of stainless steel would require a higher level of molybdenum consumption. A June 8th news item in *MEPS Steel News* forecast firm prices for molybdenum through the summer months. The news service reported, "We are bullish about stainless steel prices in the period to September, at least." But the service warned, "We have reservations about the prospect of this market continuing at the current level in the medium term. Production is starting to rise to meet current orders - a large proportion of which are speculation against rising raw material costs." They felt stainless steel prices, and possibly molybdenum, might drift lower by the end of 2006. But, they also cautioned, "This prediction assumes a decrease in the price of nickel. This is by no means a certainty in these unpredictable times in the metal market."

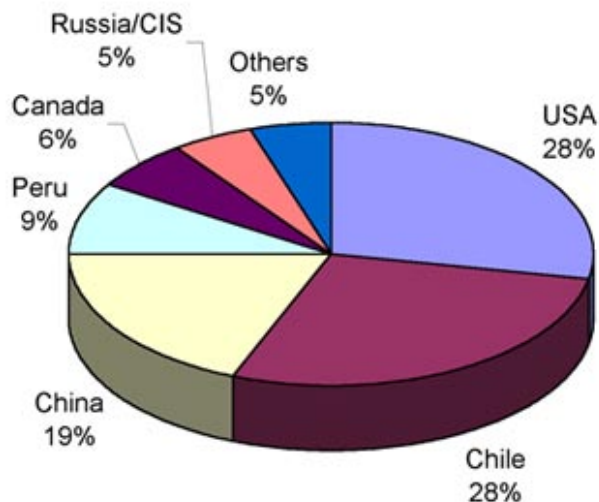
How does Smirnova feel about molybdenum's role in any perceived correction in steel or base metal prices? She doesn't see the amount of molybdenum used as a major factor, "While 75 percent of moly consumption is in various steels, the metal generally represents a small proportion of the steel, depending on the end use. It can be as low as 0.2 percent or as high as 8 percent in those steels that need extra strength and corrosion resistance. The average would be closer to the lower end of the range" Smirnova pointed, out, "In many applications the cost of moly is not significant." She cited the comparison between nickel and moly consumption as one example, "At current prices nickel would represent ten times the cost of moly in a steel using 10 percent Ni and 0.5 percent Mo."

But what if pricey copper takes a dive? "I don't think moly prices would necessarily tumble if copper prices were to go south," Smirnova told us. While some 60 percent of the molybdenum mined is a byproduct of some of the world's large copper mines, Smirnova pointed out, "The markets are quite different and the two metals have different end uses." She also observed, "On the supply side, there are fewer producers of moly than there are of copper."

And how to do those companies see demand? "Moly producers we speak with indicate that they have no problems securing buyers for the metal," Smirnova responded. "There is obviously demand, and it will provide a floor to the price." For those worrying about whether the economy will tank next year, Smirnova offered this bit of comfort, "Moly is also more insulated from certain economic downturns (than copper). If the U.S. housing market has a meltdown - signs of which we already see, moly will find support in the energy and mining sectors, unless spending is reduced in those areas." Michael Magyar writes in the USGS minerals yearbook, "The variety of uses for molybdenum materials, few of which afford acceptable substitution, has resulted in a doubling of consumption in the Western World."

Will manufacturers replace molybdenum with another metal or pay the higher cost, should moly sustain at these price levels or rise higher? Smirnova doesn't think the energy sector is likely to substitute moly with another metal, "Of course, moly substitution is possible in some applications, but its properties make it invaluable in energy-related sectors." She pointed out, "Quality outweighs cost here and I don't think anyone wants to see the

2004 Mine Production: 385 Million Pounds



The World's Top Molybdenum Producers

Mackenzie Valley pipeline corrode and leak. The same would apply to any other oil and gas project." Smirnova reminded us demand for molybdenum is unlikely to fade as long as oil and gas companies advance their projects, "This bodes well for the energy sector supporting moly demand going forward."

We talked with Michael Magyar, the USGS molybdenum commodity specialist about pricing of the metal. He explained, "The molybdenum market usually needs about 10 to 12 weeks of inventory for its comfort level." That comes to about 60 to 80 million pounds. "The amount of moly floating around right now, in the hands of producers and traders, might be about 10 million pounds." About two weeks of production.

Magyar analyzed the rapid rise of molybdenum's pricing and its drift since peaking in 2005. "Inventory only began to be rebuilt by the end of 2005, and we have a long way to go before inventory is rebuilt," he pointed out. "The seeds for this price level were sown in the fourth quarter of 2001." Molybdenum traded around \$3/pound. Copper prices were sub-\$1/pound. He explained the climate during late 2001, "The copper producers weren't making any money. Kennecott, Phelps Dodge and others decided to take production off the market in the fourth quarter (2001)." Moly prices jumped. "The reduced supply coupled with the increased demand in steel caught molybdenum producers off guard."

There were hurdles to overcome. The Chinese demand for stainless steel sent the price soaring higher in 2004, ending over \$30/pound. "There were bottlenecks leading to this price jump. Producers had to hire back the miners. Moly roasters were unprepared for the increased supply. It took them about five months to get into gear."

The question lacking a definite answer is: Will demand slack off or remain firm? Comments from China's largest molybdenum miner, the world's third largest moly producer, revealed there is strong domestic demand for the country's steel industry. He anticipated moly exports would trend lower. Will U.S. and Chilean molybdenum production suffice to match the demand?

Smirnova analyzed the current supply and demand balance, "The answer to that question depends on the time frame under consideration." She explained, "We have seen announcements from various mining companies to increase moly production, especially as a by-product of copper production. Whether these efforts will have an impact on the market is yet to be seen." Why is that? Smirnova pointed out, "For one, most of the expansions are of small scale, one to five million pounds. More importantly, the timing on the larger projects is questionable."

The Sprott Research Associate cited one example in the United States, "Phelps Dodge is planning to restart their Climax mine in Colorado pending the completion of a final feasibility study. The mine would produce 20-30 million pounds but would not commence production until the end of 2009." It is another evidence of environmental regulations helping to set the price of many commodities. She offered her insight, "This underscores the importance of permitting and the amount of hoop jumping that needs to occur for a project of that scale to materialize."

The United States is not alone with production challenges. Another of the world's top molybdenum producer is Chile, which mines molybdenum as a byproduct of copper production. "Chile has its own issues," Smirnova said. "There is a shortage of water and certain regions have stopped granting new water rights." She added more woes to the list Chilean moly producers, "Challenges such as increased environmental awareness, lengthier permitting schedules and industry-wide equipment shortages are making it more difficult to start new mines or expand capacity."

Smirnova concluded increased production may not necessarily be readily available, "From this perspective, I question the extent to which moly production can grow in the short-term." Magyar believes delays in reopening the Climax mine are related to rebuilding the Climax mill. In his opinion, Phelps Dodge faces problems such as finding skilled mine workers, refitting



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Smirnova commented on both companies:



BLUE PEARL MINING

"Blue Pearl is advancing their Davidson project near Smithers in British Columbia. We consider Blue Pearl to be cheap on a contained metal value basis and on a potential earnings basis.

The company's market cap is approximately C\$110 million. Using a 0.10 percent MoS2 cutoff grade, the deposit contains an NI 43-101 compliant resource of 588 million pounds Mo. That means investors are paying 19 cents for something that trades at around US\$25 per pound. Currently, Blue Pearl is awaiting the results of a feasibility study on mining the deposit's high-grade core, which would accelerate the payback for the project. We do not expect the mine to be in production until at least the end of 2007."



"Roca Mines is planning to begin production from their MAX project in the fall of this year utilizing their small mines permit.

The company plans to produce approximately 1.5 million pounds of moly per year from a high-grade zone grading 1.95% MoS2. The great news is that the small mining permit is already in place and the company has purchased the mill components. As well, Roca just announced an off-take agreement for 100% of their concentrate production in 2006 and 2007. Roca is trading at 2x potential cash flow at current moly prices."

engines to reduce emissions and obtaining new tires for mine equipment. "Production from the Climax mine will be needed well before the super-producing Henderson mine is exhausted in about 10 to 15 years," Magyar told us.

Current molybdenum pricing, about \$24 to \$25/pound is at a wide variance with actual production costs. "Production costs for primary molybdenum is about \$4/pound," Magyar explained. "The by-product moly is about \$2/pound, since the copper companies don't have the added mining costs - it is by-product." New primary mines, according to Magyar, might have production costs of between \$6 and \$8/pound.

Investor Exposure to Molybdenum



Roca Mines plans to be Canada's newest primary molybdenum producer in the fall of 2006 at Trout Lake in British Columbia

There is no commodities futures market in molybdenum. Yes, there are many more moly traders than trading companies buying and selling uranium. But, it is a small market. Because molybdenum mining is majorly a byproduct of copper mining, investments in Phelps Dodge is mainly a bet on the rise of copper.

He pointed out U.S. molybdenum production, the largest in the world, had reached 58,000 metric tons in 2005, up a whopping 37 percent from 2004. "Increases for 2006 will be incremental," he said. "Through May, production is up 2500 tons." In January, Magyar wrote in his monthly update, "China continued its high level of steel production and consumption, thus providing strong demand for molybdenum." There appeared to be no signs of China slowing down. Perhaps it is time to look at molybdenum companies.

We turned to Maria Smirnova for what Sprott Asset Management favors as molybdenum investments. Surprisingly, the money managers have avoided investments in several molybdenum juniors.

Smirnova told us, "Both Blue Pearl and Roca are good ways for an investor to gain exposure to molybdenum." She referred to Blue Pearl Mining and Roca Mines, both of which trade on the Toronto Venture Exchange. "They are both in a stable political environment, Canada, and are run by competent managers." (As a matter of disclosure, Sprott Asset Management has investments in both companies within its various funds.)

We were curious about Roca Mines, which late Monday announced an agreement with United Kingdom-based Derek Raphael to purchase all of the company's molybdenum concentrates produced through 2007. The British metals trader is a member of the Minor Metals Trade Association, based in Gloucestershire. According to an industry website, "Molybdenum, in all its forms, is the principal product of the company." Our curiosity grew because the Blue Pearl website announced it

was “Developing Canada’s Next Molybdenum Mine.” We heard otherwise so we passed this one by.

We talked with Scott Broughton, Chief Executive of Roca Mines, to get some background on his company. From whence came the MAX molybdenum property? Having acquired the property in 2004, Broughton told us, “It’s a deposit that was explored extensively by big companies, Newmont and Esso Minerals, back in the late 1970’s and early 1980s.” He mentioned, “They lost control of the key claims, but held control of the other surrounding ground and all of the original exploration and engineering data. It took us the rest of 2004 to negotiate a deal with Newmont, whereby we acquired the rights to their remaining property and, importantly for us, all of that engineering data in its original form.”

What did Broughton get for his money? “Drill data bases and lots of metallurgical work was done on this site,” he told us. “Newmont spent about \$15 million dollars (in 1980 dollars), developed an exploration adit, or tunnel, that goes right to the heart of the deposit.” Roca also got a good deal of the baseline study and environmental work as part of the package. “We have bought a very comprehensive engineering, mine, metallurgical, environmental, and baseline data set, as well as the property, from Newmont,” Broughton explained.



Chief Executive Scott Broughton believes the mega-producing Henderson molybdenum mine might be a good analogy for Roca Mines’s MAX project

“We have about 43 million tonnes of molybdenite,” Broughton told us. Molybdenite is the naturally occurring molybdenum sulfide mineral. “That is not an outstandingly large deposit.” But, it is a primary molybdenum deposit. There aren’t any other economic values in the rock other than moly. “What we now know from our own drilling is that there are very continuous and substantial zones of high grade,” Broughton suggested. “That presents an opportunity for us to go back to the classic way to develop a mine.”

So what is Roca Mines doing? “We’re focusing on small scale, small capital cost project,” he answered. That reduces the risk. “We got it permitted at the end of last year, and we always felt



**Molybdenite Photo from Mill
courtesy of the Smithsonian Institution**

that starting small and starting high grade was the way to go.” Broughton believes this is the classic way to build a mine.

How small is small? “What we have permitted now can produce about three million pounds of contained molybdenum, starting at the end of this year, through to the same period in 2007,” Broughton told us. At \$24/pound, that’s \$72 million in roughly about 14 months. What’s the cost to produce this moly? “We know this operation has a break even cost of \$5/pound,” he responded. But it never works out that perfectly in the real world. How did Broughton answer that challenge? “I am an engineer. We have got major contingencies built into all our operating costs, but it’s also why we’ve focused on reducing our capital cost. It’s why we are starting with a small, super high grade plant here.”

And what about expansion plans? Broughton didn’t bat an eye, “When we expand from our initial mine, we can steadily produce three million pounds per year for onwards of 10 years. That’s when we expand to a 1000-ton-per-day scenario. We intend to do that by 2008.” So, small means 500 tons per day.

Is that the whole story? On the face of it, this is a good story of mining production and consistent cash flow. While molybdenum prices may have some risk at these levels, our research confirms the next year’s price levels should remain well above production costs. A review of the National Instrument 43-101 remarks made about the moly deposit were encouraging: 42,940,000 tonnes grading 0.2 percent MOS₂ multiplied by 0.59 (the molybdenum equivalent) equals 111,368,000 pounds. According to the document filed with Canadian regulators, the gross value of the molybdenum deposit is valued at more than \$2.7 billion (using \$25/pound moly prices).

Of course, any veteran natural resource investor knows better than to buy that at face value. First, there are capital costs and operating costs. Then, no resource will be mined entirely. At best, the company might recover perhaps 90 percent. That would only come about should the moly remain high grade and if the metal’s price sustains above \$10/pound. Most U.S. molybdenum is produced as a byproduct at little cost to the mining company.

But, there are some bright sides to this. The world’s greatest concentration of molybdenum occurs in the Western Cordillera

– the mountains along the eastern half of the geological Pacific Rim of Fire, from the tip of North America to South America. The world’s largest molybdenum reserves are in the United States (about 40 percent). Roca Mines has the right geological setting (as does Blue Pearl Mining). Another aspect of the company’s security filing on their property’s geological estimates boiled down to the individual who prepared the technical report. Terry MacCauley who provided the estimate for Roca Mines had been the exploration manager for Newmont between 1976 and 1982. He had also done the initial geological mapping and geochemical survey in 1975. We readily accept MacCauley’s resource estimate in light of one who is versed in the property’s potential.

Which brings us back to the big question: where does Roca Mines go after it has begun mining moly? “We have a very interesting exploration model in the Henderson mine,” Broughton told us. “The Henderson was a deposit that was explored by Amax. They basically had an upper deposit, in a mountainside that from a physical point of view is almost an identical twin to what we have at MAX.”

Broughton continued his comparison, “It’s called Urad. It has similar size, similar tons, and similar grades to what we have. Amax observed there was multiphase mineralization. There was such a high grade in some of these zones within the deposit that they suspected a very large mineralizing source at depth.” So began the success of one of the world’s largest molybdenum-producing mines. The geologists went deeper to find the source, which was about 700 million tons of ore.

“They went from something that is around the size of a MAX project,” said Broughton. Does he believe he will repeat Amax’s success at Henderson, “I think the model is very well founded, and we’re actually assembling an advisory board to help us focus on that exploration model,” he concluded. “Once we’re in production and cash-flowing, we want to do some more exploration and to drill at depth.”

For the time being, Roca Mines will have Canada’s newest molybdenum mine, possibly as early as this year. Shares outstanding and fully diluted, even with a financing announced before the summer correction arrived, would be less than 100 million shares. If the company honors its promise and produces 300,000 pounds of molybdenum concentrate monthly at its MAX project, starting before the end of this year, and continues into 2007, then Roca will have plenty of cash flow from which to explore the depths of its molybdenum deposit to discover whether or not its “Henderson model” materializes.

Roca Mines and Blue Pearl may indeed become two vehicles for investors to play the molybdenum side of this energy bull market.

Websites and Trading Symbols of companies mentioned in this report:		
Blue Pearl Mining	www.bluepearl.ca	TSX: BLE
Roca Mines	www.rocamines.com	TSX: ROK

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