

InterDigital Communications Corp.

(IDCC- NASDAQ)

Strong Q2 Results; Recurring 3G Revenues Top \$46.0m

Rating: **Market Outperform**

Risk: Moderate

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August 3, 2006

Key Points

- **InterDigital reported 2Q06 results that exceeded the company's guidance, the consensus estimate, as well as our estimates.** Revenues of \$296.6m benefited not only from the \$228.0m Nokia settlement, but from record recurring revenues of \$55.0m. Nine licensees contributed \$1.0m or more during the quarter, but more importantly 85% of the recurring license revenues were attributable to 3G technologies. This statistic gives us confidence in management's ability to execute, attract and sign new OEMs, while moving closer to the goal of collecting royalties of every 3G unit shipped. IDCC's technology solutions program powered by the Infineon agreement is expected to generate higher revenues in 2H06 thanks in large part to a deal in place with Panasonic and a 2G deal with LG that may open the door for additional 3G related revenues.
- **InterDigital's forward-looking philosophy and active involvement in numerous standards bodies should lead to further licensing deals.** China's 3G TD-SCDMA technology appears to be ready for launch by year end and IDCC is working with several Chinese handset manufacturers to ensure IDCC is positioned to collect royalties from this large niche market. Furthermore, the company continues to take a leadership role in the development of the 802 technology family in an effort to build a patent portfolio that can be monetized once those systems become deployed.
- **As we stated in our initiation report a week ago the LG deal should be viewed as a signal suggesting future OEM deals, both large and small, will be coming.** IDCC continues to be in discussions with the remaining top-6 OEMs (Nokia, Motorola, Samsung, Sony Ericsson, and Ben Q Siemens), and it is our belief that the LG signing will spur at least one of these OEMs into a deal by the end of 2006. Additionally, IDCC has inked deals with every major Japanese OEM with the exception of Mitsubishi and Fujitsu, and we expect it is only a matter of time before they are signed. We received limited information regarding the pending Samsung settlement and can only speculate that perhaps a 3G component could be in the works.
- **Mobile handset industry sales in Q206 saw strong yr/yr and sequential growth providing IDCC with a nice tailwind.** With 462m units shipped YTD, the 1 billion unit mark is within striking distance for 2006. 3G sales experienced strong growth in 2Q06 and are now becoming a significant part of the mobile world. Strong performance from the mobile handset market is projected to continue well into the future, and it appears that IDCC has the "know how" to capitalize from this thriving market.
- **Maintaining our Market Outperform rating and increasing our price target to \$40.** We were encouraged to see that IDCC's current licensee base was able to drive recurring revenues to a record high. 2G royalty revenues are expected to fall off in 2007, but we believe the current licenses base will be more than capable of making up for that lost revenue as favorable trends in the 3G mobile handset market will drive per unit royalties. Our \$40 price target is based on a sum-of-the-parts analysis using our 2007 EPS estimate of \$0.87, projected balance sheet cash, and projected increased 3G market penetration.

SHARE DATA		EPS, REVENUE, EBITDA (FY End: Dec.)								
			2005A	-----	2006E	-----	-----	2007E	-----	
				Current	Prior	Consensus		Current	Prior	Consensus
Current Price:	\$26.87									
52 Week Range:	\$17.25-35.44									
12 Month Target:	\$40	Mar.	(\$0.02)	\$0.23		-	A	\$0.24		\$0.26
Market Value (MM):	\$1,479	June	\$0.07	\$2.98		-	A	\$0.21		\$0.25
Shares Outstanding (MM):	55.0	Sept.	\$0.11	\$0.34		\$0.36	E	\$0.21		\$0.25
Institutional Holdings:	36%	Dec.	<u>\$0.03</u>	\$0.36		<u>\$0.51</u>	E	\$0.21		<u>\$0.26</u>
Avg Daily Volume:	1,418,107	Year	\$0.20	\$3.91		\$4.04	E	\$0.87		\$1.01
Est. LT EPS CAGR	25%									
			Revenue	\$163.1	\$486.1	\$486.7		\$232.3		\$224.0
			EBITDA	\$28.5	\$76.7			\$112.0		
CAPITALIZATION (\$MM)		VALUATIONS								
Tang. BV/Share	\$5.31	P/E		7x				31x		
Net Cash/Share	\$5.90	Rel. P/E		40%				180%		
Debt / Cap:	0.36	P/Revenue		3.0x				6.4x		
		EV/Ebitda		15x				10x		

PLEASE SEE THE DISCLOSURE APPENDIX FOR RATINGS DEFINITIONS, IMPORTANT DISCLOSURES AND REQUIRED ANALYST CERTIFICATIONS ON PAGES 7 & 8.

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Company Overview

InterDigital Communications Corporation designs, develops, and licenses digital wireless technologies which are incorporated into semiconductors, mobile handsets, and other wireless equipment. With approximately 6,000 patents worldwide the company has developed an expertise in technology development and a licensing program that has generated over \$1B in license fees over the lifetime of these patents. InterDigital has been in the business of developing wireless technologies for over 30 years and was an early participant in the development of the widely used TDMA and CDMA technologies. It holds a number of essential patents pertaining to each of these technologies. The bulk of the company's revenues are generated through licensing its intellectual property, primarily to original equipment manufacturers (OEMs) of 2G, 2.5G, and 3G mobile handsets and infrastructure. Revenue is also generated through specialized engineering services and the licensing of technology solutions including software and physical layer designs.

The company is currently developing a complete 2G/3G modem platform in order to expand its offerings to include more tangible products such as chipless and fabless solutions. By taking an active role in defining widely adopted wireless standards InterDigital is continually pushing the envelope by developing new technologies, rather than relying solely on its existing patents for revenues. The company is currently involved in developing standards for 3G, Next Generation Networks (NGN), and IEEE 802.11x technologies, among others.

InterDigital was incorporated in 1972 and went public in 1981. Corporate headquarters are located in King of Prussia, PA with additional R&D teams in Melville, New York and Montreal, Quebec, Canada. The company currently employs 320 people including 202 engineers, 70% of whom hold advanced degrees, and 30 of whom hold PhDs.

Investment Risks

The realization of any or all of the following risk factors, among others, may adversely affect the company's stock price and prevent it from reaching our price target:

- **Ability to enforce patents in a changing and evolving patent landscape.** InterDigital primarily develops and licenses intellectual property and related technology to handset manufacturers and semiconductor companies. There can be no guarantee that InterDigital will be able to enforce its patents and furthermore the threat of increased patent regulations or modifications could stifle the patent licensing process.
- **Threat of litigation and arbitration.** As InterDigital seeks to license its IP there is always the threat that the company may have to invest a considerable amount of resources into defending and enforcing the validity of its patents. The timing, cost, and outcome of legal battles introduce a high degree of uncertainty into the business model.
- **Revenue volatility can be expected.** Revenues are currently concentrated on a small number of licensees and the amount contributed by each licensee can vary depending on product sales. Additionally, the timing of revenues due to prepayment agreements, settlements, and new deals cannot be accurately predicted. Furthermore, 2G patent expirations will result in lost revenue from current licensees.
- **Trying to carve out space in an industry with large established players.** Even though InterDigital has been in the business of developing IP for the wireless industry for 30 years they are still a relatively small player surrounded by well entrenched industry participants who have greater resources and established relationships.
- **Technologies and standards utilized in the wireless industry are subject to rapid change.** As 3G technologies are on the verge of experiencing widespread market adoption, WiMax and the 802 family of standards are beginning to attract considerable attention. The continued success of InterDigital rests on its ability to remain ahead of the curve while anticipating changing industry standards.
- **Technologies developed may not be implemented or may become compromised by competing solutions.** There can be no guarantee that the technologies developed by InterDigital will be adopted and deployed by the mainstream markets.

Sum of the Parts Valuation

A number of valuation techniques have surfaced as analysts have attempted to identify an accurate price target for IDCC. We believe the best approach is a sum-of-the-parts analysis that incorporates four key components: Net Cash, Pending 2G Settlement cash, current licensee cash, and projected 3G cash. We take our analysis one step further and introduce conservative, average, and aggressive 2007 penetration scenarios of the 3G handset market, which is the primary revenue driver in the IDCC story. The corresponding table and charts below summarize our valuation findings. Our per share EPS contributions are calculated as follows:

Net Cash/share = Q306 projected cash balance minus long and short term debt divided by shares outstanding

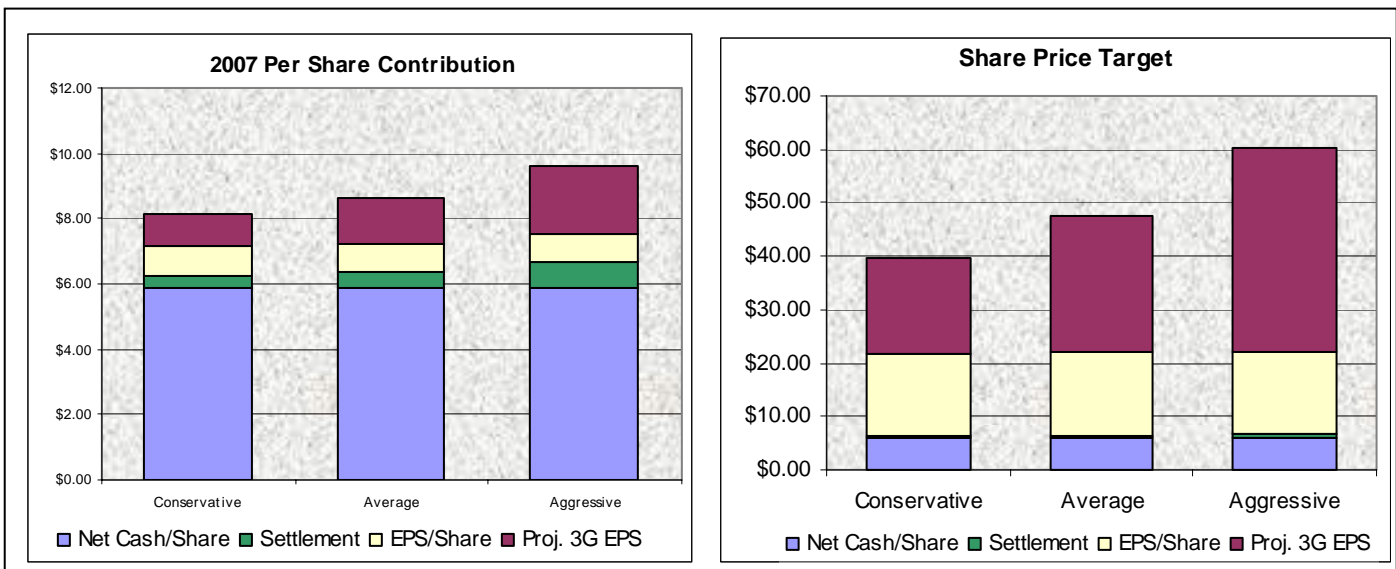
Settlement Cash/share = estimated Samsung award taxed at 36% divided by shares outstanding

EPS = our 2007 EPS estimate which relies only on current licensees and assumed growth

Projected 3G EPS = estimated 2007 EPS, derived from further 3G market penetration and assumed royalty rates, taxed at 36%.

Sum-of-the-Parts Analysis			
	Conservative	Average	Aggressive
Net Cash/Share 2Q06	\$5.90	\$5.90	\$5.90
Expected Settlement Cash/share	\$0.38	\$0.47	\$0.76
2007 EPS estimate	\$0.87	\$0.87	\$0.87
2007 Proj. 3G EPS	\$0.99	\$1.41	\$2.12
2007 Valuation Scenarios			
Net Cash/Share 2Q06	\$5.90	\$5.90	\$5.90
Expected Settlement Cash/share	\$0.38	\$0.47	\$0.76
2007 EPS estimate (18x P/E)	\$15.58	\$15.58	\$15.58
2007 Proj. 3G EPS (18x P/E)	\$17.82	\$25.46	\$38.19
Price Target	\$39.68	\$47.41	\$60.42

We assign an 18x multiple on the 2007 earnings streams, which represents the peer group average.



Valuation and Estimates Rationale

Our \$40 price target is of the conservative viewpoint, however we believe two factors could drive valuation scenarios closer to our average or aggressive targets. First, the signing of another top-six OEM should produce royalty revenues similar if not greater to the LG deal. LG owns a 6% share of the handset market and most likely got a very favorable royalty rate since it was a first mover. The next OEM to sign with IDCC can expect to see a royalty rate higher than that given to LG. Therefore, if we assume an OEM with a similar market share to LG inks the next deal royalty revenue can be expected to be at least \$285m, or \$0.68 EPS per year. Assuming IDCC signs Samsung (12% market share) that deal should net at least \$500m, or \$1.18 EPS per year. Second, we believe the large cash base will be accretive to EPS on two fronts, the stock buyback and the acquisition of complimentary IP, application software, or legacy 2G technology.

Potential investors should also realize that we have taken a very conservative approach in our financial modeling of revenues through 2007. Our model only includes revenues which we believe have a high degree of visibility, we have not tried to make any guesstimates as to the timing or amounts of future deals or projected 3G market penetration. Instead we have factored future market penetration and licensing potential into our sum-of-the-parts valuation analysis.

Income Statement

InterDigital Communications (IDCC)

December Fiscal Year (Millions)	F2003		F2004		F2005				F2006				F2007				
	Year	Year	Mar-05	Jun-05	Sep-05	Dec-05	Year	Mar-06	Jun-06	Sep-06	Dec-06	Year	Dec-07	Mar-07	Jun-07	Sep-07	Year
	(A)	(A)	(A)	(A)	(A)	(A)		(A)	(A)	(E)	(E)		(E)	(E)	(E)	(E)	
Total Revenue	114.6	103.7	35.5	38.6	48.5	40.5	163.1	51.6	296.6	67.5	70.5	486.1	60.0	57.5	57.5	57.5	232.3
COGS	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Profit	114.6	103.7	35.5	38.6	48.5	40.5	163.1	51.6	296.6	67.5	70.5	486.1	60.0	57.5	57.5	57.5	232.3
Operating Expenses																	
Cost of Product	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Sales and Marketing	4.9	6.2	2.3	1.5	1.8	2.3	7.9	1.8	1.6	2.0	2.5	7.9	2.7	2.6	2.6	2.6	10.5
General, and Administrative	18.2	21.6	6.6	5.9	5.4	6.3	24.2	5.0	5.7	6.7	7.4	24.9	7.2	7.2	7.2	7.2	28.9
Patents Administration and Licensing	16.0	30.3	11.2	10.1	14.7	13.4	49.4	10.0	12.8	14.5	13.0	50.3	11.0	11.0	11.0	11.0	44.0
Development	45.9	51.2	16.2	14.9	15.6	16.4	63.1	16.0	15.9	17.5	19.0	68.5	21.0	21.3	21.4	21.8	85.5
Repositioning	0.0	0.6	0.0	0.0	0.8	0.6	1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Operating Expenses	85.0	110.0	36.3	32.5	38.4	38.3	146.0	32.8	35.9	40.8	41.9	151.5	41.9	42.1	42.2	42.7	168.8
Operating Income	29.5	(6.3)	(0.8)	6.2	10.2	2.2	17.1	18.8	260.7	26.6	28.6	334.6	18.1	15.4	15.2	14.8	63.5
Interest Income	1.8	2.0	0.8	0.7	0.8	0.9	3.2	1.5	3.9	3.5	3.5	12.4	3.5	3.5	3.5	3.8	14.3
Interest Expense	(0.2)	(0.3)	(0.0)	(0.0)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Income before Taxes	41.7	(4.5)	0.0	6.8	10.9	3.1	20.9	20.3	264.6	30.1	32.1	347.0	21.6	18.9	18.7	18.5	77.7
Income Taxes	(7.3)	4.7	0.9	2.8	4.4	1.1	9.3	7.4	94.2	10.9	11.5	124.0	7.8	6.8	6.7	6.7	28.0
Net Income	34.5	0.2	(0.9)	4.0	6.5	2.0	11.6	12.9	170.3	19.3	20.5	223.0	13.8	12.1	12.0	11.9	49.7
Diluted Earnings per Share	\$0.58	\$0.00	(\$0.02)	\$0.07	\$0.11	\$0.03	\$0.20	\$0.23	\$2.98	\$0.34	\$0.36	\$3.91	\$0.24	\$0.21	\$0.21	\$0.21	\$0.87
Diluted Shares Outstanding	59.69	59.08	55.05	56.79	57.09	57.16	57.16	56.88	57.13	57.20	57.22	57.11	57.30	57.40	57.50	57.60	57.45
Margins																	
Gross Margin	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Research and Development	40.1%	49.4%	45.6%	38.7%	32.2%	40.5%	38.7%	31.0%	31.0%	26.0%	27.0%	14.1%	35.0%	37.0%	37.3%	38.0%	36.8%
Selling, General, and Administrative	4.3%	6.0%	6.4%	4.0%	3.7%	5.7%	4.9%	3.5%	0.8%	3.0%	3.5%	6.7%	4.5%	4.5%	4.5%	4.5%	16.9%
Operating Margin	25.8%	-6.1%	-2.2%	15.9%	20.9%	5.4%	10.5%	36.4%	87.9%	39.5%	40.5%	68.8%	30.2%	26.8%	26.5%	25.8%	27.3%
Net Margin	30.1%	0.1%	-2.5%	10.4%	13.4%	4.8%	7.1%	25.0%	57.4%	28.6%	29.1%	45.9%	23.0%	21.0%	20.9%	20.7%	21.4%
Tax Rate	17.4%	103.4%	-4300.0%	-41.3%	-40.4%	0.0%	0.0%	-36.4%	35.0%	36.0%	36.0%	35.7%	36.0%	36.0%	36.0%	36.0%	-36.0%
Growth Rates																	
Revenue, yr/yr	30.4%	-9.5%	7.5%	31.4%	559.7%	19.3%	57.3%	45.4%	668.4%	39.0%	74.0%	198.0%	16.2%	-80.6%	-14.8%	-18.5%	-52.2%
Gross Profit, yr/yr	30.4%	-9.5%	7.5%	31.4%	559.7%	19.3%	57.3%	45.4%	668.4%	39.0%	74.0%	198.0%	16.2%	-80.6%	-14.8%	-18.5%	-52.2%
Research and Development, yr/yr	13.6%	26.1%	41.3%	10.1%	28.5%	28.3%	27.6%	-20.0%	1.5%	12.5%	7.3%	-0.5%	47.9%	65.7%	27.8%	4.8%	32.8%
Selling, General, and Administrative, yr/yr	25.6%	18.9%	21.8%	8.9%	7.4%	8.6%	11.7%	-23.5%	-3.7%	24.4%	18.3%	2.9%	43.3%	27.1%	7.3%	-2.1%	16.3%
Operating Income, yr/yr	219.7%	-121.3%	-109.5%	180.7%	-153.1%	-15.4%	-371.6%	-2540.7%	4137.6%	162.1%	1216.4%	1858.4%	-3.7%	-94.1%	-42.9%	-48.2%	-81.0%
Net Income, yr/yr	1272.6%	-99.6%	-115.1%	351.7%	-201.9%	-1295.1%	7393.5%	-1561.3%	4146.6%	195.6%	947.0%	1820.2%	7.1%	-92.9%	-37.9%	-42.2%	-77.7%
Diluted EPS, yr/yr	1258.6%	-99.5%	-116.4%	387.7%	-198.7%	-1335.1%	7644.5%	-1514.3%	4121.5%	195.1%	946.0%	1822.0%	6.4%	-92.9%	-38.2%	-42.5%	-77.8%

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Source: IDCC filings, Boenning & Scattergood

Balance Sheet

InterDigital Communications (IDCC) Balance Sheet

December Fiscal Year (Millions)	2003		2004			2005				2006	
	Dec.	March	June	Sept.	Dec.	March	June	Sept	Dec	March	June
Balance Sheet											
Cash and cash equivalents	20.9	25.8	40.9	44.2	15.7	13.9	11.9	41.1	27.9	64.1	336.8
Short Term Investments	85.1	99.6	82.4	100.7	116.1	112.6	88.1	73.2	77.8	132.9	0.0
Accounts receivable, net	37.8	36.3	55.9	6.6	11.6	9.9	15.6	14.8	19.5	113.4	115.1
Deferred income taxes	0.0	0.0	0.0	3.5	5.2	4.9	7.8	6.4	42.1	62.2	46.5
Prepaid Expenses	8.6	8.0	6.9	6.2	8.0	8.5	6.5	6.8	8.4	13.1	14.2
Prepaid Income Taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Current Assets	152.4	169.7	186.1	161.2	156.6	149.8	130.0	142.2	175.7	385.7	512.7
Property, Plant, and Equipment, net	12.1	11.2	10.8	10.7	10.7	11.9	11.3	10.9	10.7	12.6	78.1
Patents, net	32.2	33.8	35.7	37.9	41.0	51.5	54.2	56.6	59.5	62.0	0.0
Deferred Tax Assets, net	0.0	0.0	0.0	23.3	27.2	26.5	20.9	17.9	48.7	55.8	27.8
Other non-current assets	8.4	11.2	11.9	12.1	6.5	5.6	5.5	5.2	5.0	14.2	0.0
Total non-current assets	52.8	56.2	58.4	84.0	85.3	95.5	91.9	90.6	123.8	144.7	105.9
Total Assets	205.2	225.9	244.5	245.2	241.9	245.3	221.9	232.8	299.5	530.4	618.6
Current Portion of LTD	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.4	0.4	0.4
Accounts Payable	6.4	3.9	4.1	5.9	6.8	7.8	6.2	5.7	7.2	7.0	33.2
Accrued Compensation and related expenses	7.6	5.5	7.2	9.1	9.3	9.0	10.5	11.9	17.0	6.0	0.0
Deferred revenue	22.4	22.3	26.8	27.9	28.1	25.9	21.6	25.3	20.1	73.7	104.3
Foreign and Domestic Taxes Payable	1.3	2.8	0.9	0.1	0.4	0.1	0.1	0.1	0.2	15.8	0.0
Other accrued expenses	2.2	3.0	6.8	4.3	5.1	4.1	5.5	8.3	5.8	8.4	0.0
Total Current Liabilities	40.1	37.8	46.0	47.5	49.8	47.1	44.3	51.5	50.5	111.3	137.8
Long Term Debt	1.8	1.7	1.7	1.6	1.7	1.8	1.8	1.7	1.6	1.5	0.0
Long Term Deferred Revenue	64.2	74.3	79.0	84.8	71.1	85.3	83.9	76.4	71.2	213.2	172.2
Other Long Term Liabilities	1.6	1.6	1.6	1.6	3.6	1.5	0.4	1.2	1.9	2.7	4.9
Total Liabilities	107.7	115.5	128.2	135.5	126.3	135.7	130.3	130.7	125.2	328.6	314.9
Preferred Stock	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Common Stock	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.0
Additional Paid in capital	305.3	313.0	323.1	338.3	342.8	354.7	355.9	357.7	383.5	392.2	0.0
Accumulated Deficit	(164.6)	(158.8)	(158.0)	(164.4)	(164.5)	(165.4)	(161.4)	(154.9)	(109.8)	(96.9)	0.0
Accumulated Other Comp. Loss	(0.3)	(0.2)	(0.6)	(0.6)	(0.1)	(0.2)	(0.1)	(0.2)	(0.2)	(0.2)	0.0
Unearned Compensation	(0.7)	(1.2)	(6.1)	(4.5)	(3.3)	(11.2)	(9.5)	(7.3)	(5.8)	0.0	0.0
Retained Earnings	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Treasury Stock	42.8	42.8	42.8	59.8	59.8	68.9	93.9	93.9	93.9	93.9	0.0
Total Shareholders Equity	97.5	110.5	116.3	109.7	115.7	109.6	91.6	102.1	174.3	201.8	303.6
Total Liabilities and Stockholders Equity	205.2	225.9	244.5	245.2	241.9	245.3	221.9	232.8	299.5	530.4	618.5
Leverage and Liquidity											
Long-Term Debt to Capital	0.4	0.4	0.4	0.4	0.4	0.4	0.5	0.4	0.3	0.5	0.4
Current Ratio	3.8	4.5	4.0	3.4	3.1	3.2	2.9	2.8	3.5	3.5	3.7
Per Share Data											
Cash & Equivalents	1.77	2.10	2.09	2.62	2.23	2.30	1.76	2.00	1.85	3.46	5.90
Net Working Capital	1.88	2.21	2.37	2.06	1.81	1.86	1.51	1.59	2.19	4.82	6.56
Tangible Book Value	1.63	1.85	1.97	1.98	1.96	1.99	1.61	1.79	3.05	3.55	5.31

Rating and Price Target History (IDCC)



Analyst Certification

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Our three-tier investment ratings are based on a stock's return potential relative to a broad market index:

Market Outperform (Buy): The security's total return over the year or longer is expected to exceed the total return of the S&P 500TM over the identical period.

Market Perform (Hold): The security's total return over the next year or longer is expected to be roughly equivalent to the total return of the S&P 500TM over the identical period.

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Low risk: The security has higher-than-average fundamental predictability and/or lower-than-average price volatility.

Moderate risk: The security has average fundamental predictability and/or average price volatility.

High risk: The security has lower-than-average fundamental predictability and/or higher-than-average price volatility.

Speculative: The security has very inconsistent fundamental predictability and/or very high relative price volatility.

Ratings Distribution (07/24/06):

<u>Coverage Universe</u>	<u>% of Universe</u>	<u>Investment Banking Clients (a)</u>	<u>% of Rating Group</u>
Market Outperform (Buy)	59%	Market Outperform (Buy)	4%
Market Perform (Hold)	41%	Market Perform (Hold)	6%
Market Underperform (Sell)	0%	Market Underperform (Sell)	0%

(a) Related to services provided within the past 12 months.

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