Latin America | Peru
Diversified Metals & Mining (GICS) | **Metals & Mining (Citi)**

Company Focus

8 April 2008 | 46 pages

Southern Copper Company (PCU)

Initiation of coverage ☑

Initiate with a Sell; Great Assets But Too Expensive.

- **Too Expensive** — We initiate coverage on Southern Copper with a Sell (3H) rating and $102 price target. PCU is a world-class mining company with low-cost, long-life reserves and exposure to a strong copper market. Yet, the shares appeared relatively overvalued. We remain structurally positive on the metals super-cycle, but right now we see more value in other mining names.
- **Premium Valuation** — PCU is trading at 13x 2008/09E EPS, a 20%+ premium to its peers. Citi expects the copper price to decline beyond 2009 – and 13x is too high of a multiple for "peak" earnings. Modeling suggests that PCU shares are already discounting a bullish scenario of over $2/lb long-term copper.
- **Copper: Short-Term Negative** — We are negative on the short-term outlook for copper expecting a pull-back to $3.50/lb on moderation of short-covering and 1Q supply problems. We are in no rush to buy PCU with copper at $3.95 and expect a retreat in the copper price to lead the shares lower.
- **Copper: Long-Term Positive** — Copper has structural supply-side challenges supporting a positive long-term outlook: falling ore grades, political risk in African projects, power shortages in Chile/China and ballooning capex budgets.
- **M&A** — PCU's assets would be highly desirable to any global miner but we do not expect the controlling shareholder to sell. Nor do we expect PCU to turn acquirer and diversify – excess cash should continue to funnel into dividends.

Sell/High Risk	**3H**
Price (08 Apr 08)	US$117.60
Target price	US$102.00
Expected share price return	-13.3%
Expected dividend yield	5.5%
Expected total return	**-7.7%**
Market Cap	US$34,629M

Price Performance (RIC: PCU.N, BB: PCU US)

Estimates	**2007A**	**2008E**	**2009E**	**2010E**	**Q108E**	**Q208E**	**Q308E**	**Q408**
Sales (US$ M)	6,086	6,709	7,214	6,074	1,528	1,637	1,754	1,79
EBITDA adj (US$ M)	3,824	4,247	4,513	3,279	931	1,049	1,121	1,14
EBITDA margin adj (%)	62.8	63.3	62.6	54.0	61.0	64.1	63.9	63
Net income (US$ M)	2,229	2,604	2,766	1,880	564	642	691	70
EPS (US$)	7.57	8.84	9.39	6.39	1.92	2.18	2.35	2.4

Valuation				
EV/EBITDA adj	9.1	8.1	7.6	10.5
PE	15.5	13.3	12.5	18.4
FCF (%)	6.9	6.3	5.9	3.8

Ratios	**2007A**	**2008**
ROE adj (%)	59.5	61
ROIC adj (%)	54.2	58
Total debt capital	27.3	24

Source: Company Reports and dataCentral, Citi Investment Research.

Alexander Hacking, CFA
+1-415-951-1704
alex.hacking@citi.com

Gabriel Gonzalez[1]
ggonzalez@accival.com.mx

See Appendix A-1 for Analyst Certification and important disclosures.

[1]Acciones y Valores Banamex, S.A. de C.V

Fiscal year end 31-Dec	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	17.0	15.5	13.3	12.5	18.4
EV/EBITDA adjusted (x)	10.5	9.1	8.1	7.6	10.5
P/BV (x)	9.5	9.0	7.6	6.6	6.3
Dividend yield (%)	4.4	5.8	5.6	6.0	4.1
Per Share Data (US$)					
EPS adjusted	6.92	7.57	8.84	9.39	6.39
EPS reported	6.92	7.57	8.84	9.39	6.39
BVPS	12.37	13.08	15.49	17.71	18.75
DPS	5.13	6.80	6.60	7.05	4.79
Profit & Loss (US$M)					
Net sales	5,460	6,086	6,709	7,214	6,074
Operating expenses	-2,406	-2,589	-2,826	-3,101	-3,262
EBIT	**3,054**	**3,496**	**3,883**	**4,113**	**2,811**
Net interest expense	-35	-26	-37	-28	-29
Non-operating/exceptionals	-13	-43	0	0	0
Pre-tax profit	**3,006**	**3,428**	**3,847**	**4,085**	**2,783**
Tax	-959	-1,189	-1,231	-1,307	-890
Extraord./Min.Int./Pref.div.	-9	-10	-12	-12	-12
Reported net income	**2,038**	**2,229**	**2,604**	**2,766**	**1,880**
Adjusted earnings	2,038	2,229	2,604	2,766	1,880
Adjusted EBITDA	3,329	3,824	4,247	4,513	3,279
Growth Rates (%)					
Sales	33.3	11.5	10.3	7.5	-15.8
EBIT adjusted	47.0	14.5	11.1	5.9	-31.6
EBITDA adjusted	41.3	14.9	11.0	6.3	-27.3
EPS adjusted	45.5	9.4	16.8	6.2	-32.0
Cash Flow (US$M)					
Operating cash flow	**2,059**	**2,685**	**2,720**	**3,145**	**2,441**
Depreciation/amortization	275	328	363	400	468
Net working capital	-182	28	-219	7	120
Investing cash flow	**-725**	**-234**	**-530**	**-1,100**	**-1,115**
Capital expenditure	-456	-304	-530	-1,100	-1,115
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**-1,164**	**-2,082**	**-1,942**	**-2,074**	**-1,410**
Borrowings	356	-79	0	0	0
Dividends paid	-1,509	-2,003	-1,942	-2,074	-1,410
Change in cash	**147**	**386**	**248**	**-29**	**-84**
Balance Sheet (US$M)					
Total assets	**6,353**	**6,503**	**7,224**	**7,892**	**8,207**
Cash & cash equivalent	1,302	1,409	1,657	1,628	1,544
Accounts receivable	604	463	696	701	590
Net fixed assets	3,547	3,568	3,735	4,435	5,082
Total liabilities	**2,699**	**2,634**	**2,648**	**2,660**	**2,669**
Accounts payable	216	255	270	282	291
Total Debt	1,529	1,450	1,450	1,450	1,450
Shareholders' funds	**3,655**	**3,869**	**4,576**	**5,232**	**5,538**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	61.0	62.8	63.3	62.6	54.0
ROE adjusted	58.4	59.5	61.9	56.6	35.0
ROIC adjusted	51.3	54.2	58.1	54.6	33.9
Net debt to equity	6.2	1.0	-4.5	-3.4	-1.7
Total debt to capital	29.5	27.3	24.1	21.7	20.7

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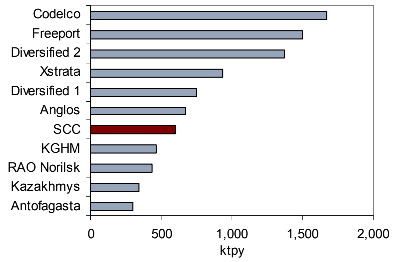
Introduction & Investment Thesis

We are initiating coverage on Southern Copper (PCU) with a Sell (3H) rating and $102 price target.

Figure 1. Top Copper Producers (2007)



Source: BrookHunt

Company Description

Southern Copper is one of the largest copper producers in the world, with mines located in Mexico and Peru. The company has the highest copper reserves of any publicly traded company – equivalent to 100+ years of production at current prices. By-product credits are large with 2007 sales split: 69% copper, 18% molybdenum, 6% zinc, 4% silver and 3% other.

Cash costs are very low driven by large-scale open pit mines, high by-product credits and sizeable SX/EW production. An ongoing labor stoppage at the Cananea mine in Mexico has reduced 2007/08E production.

Investment Thesis

Southern Copper is an excellent mining company with top-tier assets, strong organic growth opportunities and a high dividend payout.

We remain structurally positive on copper given supply-side challenges from falling ore grades, political risks, power shortages and rising capex costs.

Yet, we would not be buyers of Southern Copper's shares at today's price. Our Sell recommendation is a valuation call.

Key concerns are:

- **Mid-cycle multiple on "peak" earnings** – PCU is trading at 12.5x our 2009 earnings estimate which assume full production and $3.50 copper. We have to look out to 2011 for new capacity and meaningful earnings growth. Mining companies have historically traded closer to 6-8x peak earnings.
- **High relative valuation** – PCU's earnings multiples are significantly higher than for its closest peers, Freeport and Antofagasta.
- **Short-term weakness in the copper price** – We expect copper to pull back to $3.50 in 2H/08 (-11% from current). A falling copper price will represent a headwind for the stock given that the multiple is already generous.
- **No M&A catalyst** – We do not anticipate that the controlling shareholder in Southern Copper would be willing to sell.

Figure 2. Copper Valuations (Consensus)

	PE		EV/EBITDA	
	2008	**2009**	**2008**	**2009**
Southern Copper	13.2x	12.5x	8.1x	7.7x
Freeport	10.6	9.7	5.1	4.7
Antofagasta	11.2	12.4	5.0	5.2
PCU Premium	22%	14%	61%	58%

Source: First Call, Citi Investment Research

When to Buy? We would be more comfortable buying Southern Copper under 10x P/E, or when copper is trading below $3.50/lb.

Other Options in Mining. Our favorite LatAm mining stock is Vale (RIO_p.N; US$30.68; 1M); and for copper exposure we prefer Freeport (FCX.N; US$107.75; 1H) analyst John Hill).

Valuation – Southern Copper

Below we discuss our thoughts on Southern Copper's current valuation and the derivation of our target price.

Current Valuation

We expect Southern Copper's shares to weaken in the short-term. Concerns on valuation include:

- **Mid-cycle multiple on peak earnings:** Southern Copper is currently trading at 12.5x 2009E EPS. Mining multiples tend to be counter-cyclical, i.e. the P/E tends to shrink as the copper price and earnings rise,

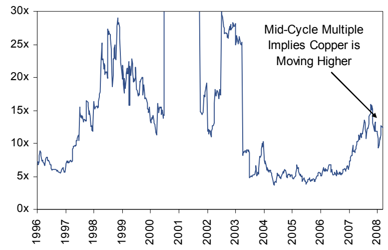
  Mining companies have historically traded around 6-8x "peak" earnings. Citi expects the copper price to decline beyond 2009 – and thus 12.5x seems too expensive.

- **High relative valuation:** Southern Copper is the most expensive of the pure play copper names on any short-term earnings metric.

  Some premium may be justified by PCU's low costs, long reserves and lack of significant geographic risk. Yet, this must be balanced by the company's unfavorable ownership structure and lack of M&A prospects.

  For copper exposure we would prefer Freeport. Freeport trades at lower multiples than Southern Copper and also might be an M&A target.

Figure 3. PCU Fwd P/E Multiple



Source: StockVal and Citi Investment Research

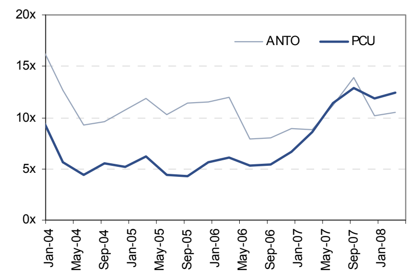
Figure 4. Global Copper Company Valuation Comparables (Citi Estimates)

Global Mining Comps	Rating	Mkt Cap US$m	PE 07A	PE 08E	PE 09E	EV/EBITDA 07A	EV/EBITDA 08E	EV/EBITDA 09E	FCF Yield 07A	FCF Yield 08E	FCF Yield 09E	Capacity kTpy	Capacity EV/	Reserves mT	Reserves EV/
Copper															
Southern Copper Co	Sell (3H)	34,629	15.5	13.3	12.5	9.1	8.1	7.6	7%	6%	6%	1,543	$22	38.2	$0.91
Freeport McMoran	Buy (1H)	41,243	11.4	9.7	8.8	6.1	4.4	4.0	-21%	12%	15%	1,710	$24	35.1	$1.18
Antofagasta PLC	Hold (2M)	15,192	11.0	10.6	11.7	5.1	4.7	4.9	6%	9%	5%	540	$28	6.7	$2.27
First Quantum Minerals	Buy (1M)	5,910	11.6	6.6	5.4	6.2	3.7	2.7	-1%	8%	20%				
Kazakhmys Plc	Hold (2H)	15,241	11.4	11.6	9.6	6.3	6.4	5.0	-2%	7%	8%				
KGHM Polska Miedz	Sell (3H)	9,446	5.4	6.4	9.1	3.0	3.4	5.1	23%	12%	7%				
Vedanta Resources	Hold (2H)	12,998	13.3	10.0	7.8	5.1	4.0	3.0	-16%	2%	12%				

(ANTO.L; £7.75; 2M), (FQM.L; £44.51; 1M), (KAZ.L; £16.85; 2H), (KGHM.WA; Zl103.90; 3H), (VED.L; £22.69; 2H)

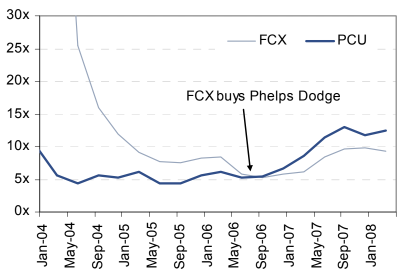
Note: Copper reserves priced at $0.90/lb

Figure 5. PCU vs. Antofagasta (Fwd P/E)



Source: Citi Investment Research

Figure 6. PCU vs. Freeport (Fwd P/E)



Source: Citi Investment Research

NAV modeling suggests that PCU is already discounting $2.25/lb long-term copper

- **$2.25/lb long-term copper already in the price:** Below we show our NAV modeling sensitivities. $2/lb is a realistic long-term copper price – but this is already discounted in Southern Copper's share price.

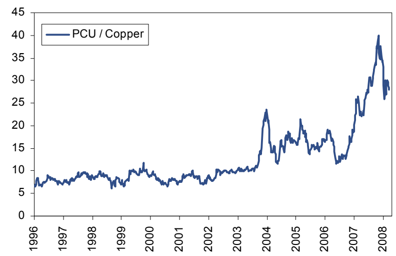
Figure 7. Southern Copper NAV Sensitivities

		LT Copper Price (US$/lb)				
	$91	$1.45	$1.75	$2.00	$2.50	$3.50
WACC	8.4%	91	99	107	123	160
	10.0%	78	85	91	103	132

Note: Citi's long-term copper price is $1.45/lb

Source: Citi Investment Research

Figure 8. PCU / Copper Price



Source: Bloomberg and Citi Investment Research

- **High valuation relative to the copper price:** Southern Copper historically traded at 10x the copper price. This ratio is now at 30x.

  The relationship between the copper price and earnings/cash flows is not linear – but the huge discrepancy in this relationship leaves more room for downside than upside, in our view.

Target Price

Our target price on Southern Copper is $102/share. We value the company using a 50:50 mix of PE multiples and DCF modeling.

Figure 9. PCU Valuation Summary

Southern Copper Valuation Summary	Weight	2009	Target Multiple	Target Price
P/E Multiples	50%	$9.39	10.0x	$94
DCF	50%	$91	1.2x	$110
Average				$102

Source: Citi Investment Research

Multiples

We apply a 10x multiple to 2009 EPS to generate a target price $94 per share.

Multiples tend to be counter-cyclical, i.e. the P/E multiple tends to shrink as the copper price and earnings rise, and vice versa.

The recent range of Forward P/E multiple for pure-play copper stocks such as Southern Copper and Freeport has been 5-15x. We chose the mid-point of this range given our view that the short-term copper price will fall, but the longer-term outlook remains positive.

DCF Modeling

Our DCF model for Southern Copper suggests a value of $91 per share using Citi's long-term copper forecast of $1.45/lb. We apply a 20% premium to this multiple for a target of $110 per share. Historically mining company stocks trade in the range of -10% to +40% of NAV. Also note:

- The current Southern Copper share price is discounting approximately $2.25/lb long-term copper.
- NAV rises to $160 at closer to today's spot copper price of $3.50.

DCF modeling is highly sensitive to long-term copper price assumptions. PCU is discounting over $2/lb at today's share price.

Figure 10. PCU DCF Sensitivities

		LT Copper Price (US$/lb)				
	$91	$1.45	$1.75	$2.00	$2.50	$3.50
WACC	8.4%	91	99	107	123	160
	10.0%	78	85	91	103	132

Source: Citi Investment Research

(We calculate an 8.4% WACC for Southern Copper using the following assumptions - risk free: 4.6%, ERP: 2.6%, Beta 1.7x, tax rate 30%, target debt rate 30%.)

Operating Projections

Below we show summary operating projections for Southern Copper.

Figure 11. Southern Copper Operating Projections (US$m)

	2007	2008E	2009E	2010E
Sales (kT):				
Copper	604	624	674	674
Moly	16	17	19	19
Price ($/lb):				
Copper	3.23	3.55	3.50	3.00
Moly	29.91	31.82	30.00	20.00
Cash COGS (ex-By Products)	1.40	1.40	1.40	1.44
Financial (US$m):				
EBITDA	3,824	4,247	4,513	3,279
EV/EBITDA	9.1x	8.1x	7.6x	10.6x
EPS	7.57	8.84	9.39	6.39
P/E	15.5x	13.3x	12.5x	18.4x
Free Cash Flow	2,381	2,190	2,045	1,326
FCF Yield	7%	6%	6%	4%

Source: Citi Investment Research

- **Copper Price:** We assume that the copper price falls from the current price of $3.95/lb to $3.50 in 2H/08 and 2009.
- **Molybdenum Price:** We expect moly to hold $30/lb in both 2008 and 2009 on strong demand from global steelmakers and tight supply.
- **Production:** 2008E production is slightly higher than 2007 on the assumption that full production is resumed at the Cananea mine in 2H/08 (current output is estimated at 20-30%). Production in 2009/10 assumes no major outages. PCU has no major growth projects before 2011.
- **Cash COGS:** We expect PCU's cash costs to be flat in 2008/09 as Cananea ramps back up to full production – this offsetting 10-15% energy-driven cost inflation. Beyond 2011, PCU's costs should benefit from the new Tia Maria SW/EW plant.

Earnings Sensitivities To Commodity Prices

Below we show PCU's EPS sensitivities to changes in commodity prices:

Figure 12. PCU EPS Sensitivities

		EPS			
		2008E	%	2009E	%
Copper	$0.10/lb	$0.32	4%	$0.34	4%
Moly	$1.00/lb	0.09	1%	0.10	1%
Zinc	$0.10/lb	0.07	1%	0.07	1%
Silver	$1.00/oz	0.05	1%	0.06	1%

Source: Citi Investment Research

Risks

We rate Southern Copper a High risk stock. The company operates in historically volatile commodity markets, yet these risks are mitigated by the company's production diversity (with two large mines in both Mexico and Peru) and low operating costs.

Key risks include:

- **Copper Price:** Southern Copper's earnings are highly leveraged to the copper price. A global recession could cause a major decline in this price (50% or more). Similarly power shortages or other major supply-side disruptions could continue to drive the price to new record highs.

- **Production Disruptions:** Southern Copper faces possible risks to production targets including earthquakes, labor stoppages, or power shortages.

- **Economic / Political Instability:** Southern Copper operations in Mexico and Peru. Both of these countries have historically faced periods of high volatility in inflation and currency. Southern Copper's costs are denominated locally, while revenues are in US dollars. A weak US dollar can result in lower margins.

- **Energy Costs:** Approximately 1/3rd of mining costs are related to energy. Continued inflation in oil and power which are not matched by a similar rise in the copper price would squeeze margins. Conversely a fall in energy costs would cause earnings to be well above our estimates.

- **Ownership Structure:** Southern Copper is 75% owned by Grupo Mexico, which is itself majority owned by the Larrea family. Such consolidated holdings can sometimes result in corporate decisions that are contrary to the best interests of minority shareholders.

- **M&A:** The Larrea family may decide to sell Southern Copper which would likely result in considerable upside to shareholders.

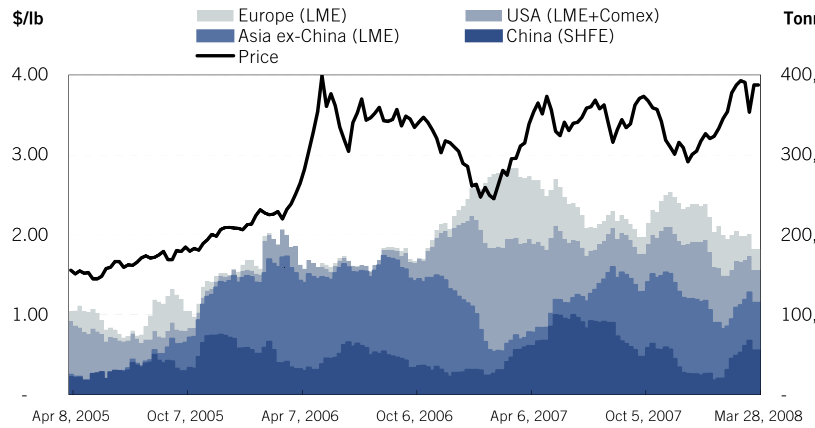
Copper Market Outlook

Short-Term Copper: Prices Likely To Weaken in 2H/08

We are short-term negative on copper expecting a pull-back to $3.50/lb in 2H/08, driven by a moderation of short-covering and supply-side disruptions.

Copper has rallied to the $3.95/lb level, from December lows of $2.85. Supply-side disruptions have been a key driver with weather problems in China and Australia, energy issues in Zambia and an ongoing strike in Mexico. Short-covering and speculators taking net-long positions have also been factors. We expect moderation of these two factors to pull copper back down to $3.50/lb by 2H/08.

Figure 13. Copper Price and Inventories by Region



Historical Prices ($/lb)	3/28/2008	QTD	YTD ave	YTD chg	2007 end
Copper Prices ($/lb)	3.87	3.51	3.51	27.9%	3.03
Price Outlook ($/lb)	**2008**	**2009**	**2010**	**2011**	**2012**
Copper Futures	3.66	3.65	3.46	3.29	3.13
Citi Forecasts	3.10	3.50	3.00	2.50	2.58
Brook Hunt (1Q/08)	3.40	2.65	1.90	1.38	1.30
Inventory Position (kT)	**Current**	**2007**	**2006**	**YTD chg**	**Days**
All Exchanges	182	237	245	-23.2%	3.7
Total Reported Stocks		703	760		14.2
Speculative Position (contracts)	**Current**	**12m High**	**High Date**	**12m Low**	**Low Date**
CMX Net Long/Short	7,294	9,944	3/11/08	-15,906	3/27/2007
Merchant Premia (Avg)	**Jan-08**	**Dec-07**	**Nov-07**	**2006**	**2005**
U.S. E. Coast (¢/lb)	5.3	5.0	4.8	6.4	6.6
W Europe Grade A ($/T)	30	30	30	110	67
Shanghai Grade A ($/T)	50	50	55	98	113
TC/RC's (Avg)	**Feb-08**	**Jan-08**	**Dec-07**	**2006**	**2005**
Spot Total F. East TC/RC (¢/lb)	7.3	11.8	11.8	13.4	37.2

Source: Brook Hunt, LME and Citi Investment Research

Recent developments in the copper markets include:

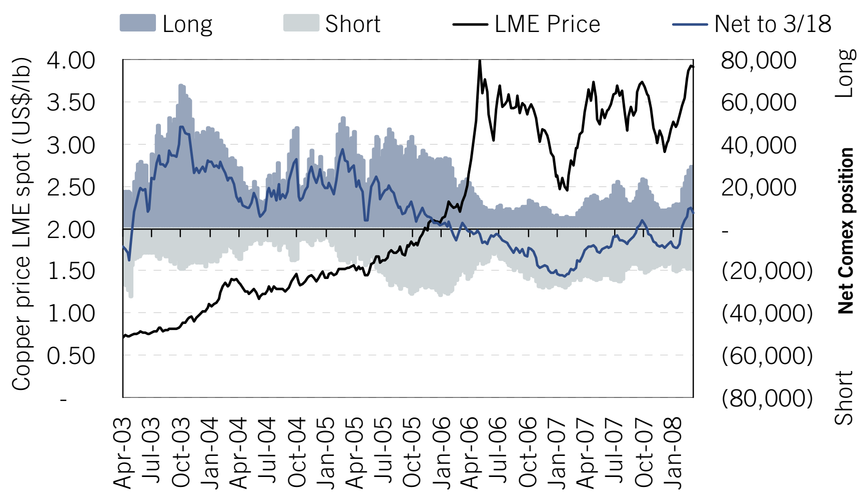
- **Low Inventories** — Total copper exchange inventories are at low levels having fallen 23% YTD. Inventories have been depleting in Asia ex-China, USA and Europe while China inventories have been building. The exchange stock ratio is about 4 days consumption.

- **Speculators Now Net Long –** As indicated by non-commercial positions in futures contracts on the COMEX, speculators are again back in net-long territory.

  On the LME the speculative breakdown is not disclosed. But, the dramatic increase in open positions with rising prices points to new longs being established in the first quarter. Again this has shown tentative signs of unwinding with open interest and net longs haven falling since early March.

Comex Speculators have moved net-long, driven primarily by new longs rather than short covering.

Figure 14. Comex Speculative Interest



Source: Comex, LME and Citi Investment Research

- **Demand From China Offsetting US Weakness –** YTD demand growth from China is more than offsetting any weakness from the US. China now consumes more than 2x the copper of the US. Yet, US economic weakness remains a threat and the lack of visibility is disconcerting.

Chinese demand is more than offsetting US weakness

Figure 15. Copper Demand Forecasts

World Copper Consumption								
kT	2007	y/y	2008E	y/y	2009E	y/y	2010E	y/y
China	4,600	16%	5,060	10%	5,465	8%	5,848	7%
US	2,152	1%	2,108	-2%	2,139	1%	2,147	0%
W. Europe	3,634	-7%	3,596	-1%	3,628	1%	3,638	0%
Japan	1,267	-3%	1,268	0%	1,280	1%	1,289	1%
Asia	3,650	6%	3,833	5%	4,002	4%	4,149	4%
Other	2,830	2%	2,917	3%	3,028	4%	3,101	2%
Total	18,133	3%	18,782	4%	19,542	4%	20,172	3%

Source: Brook Hunt and Citi Investment Research

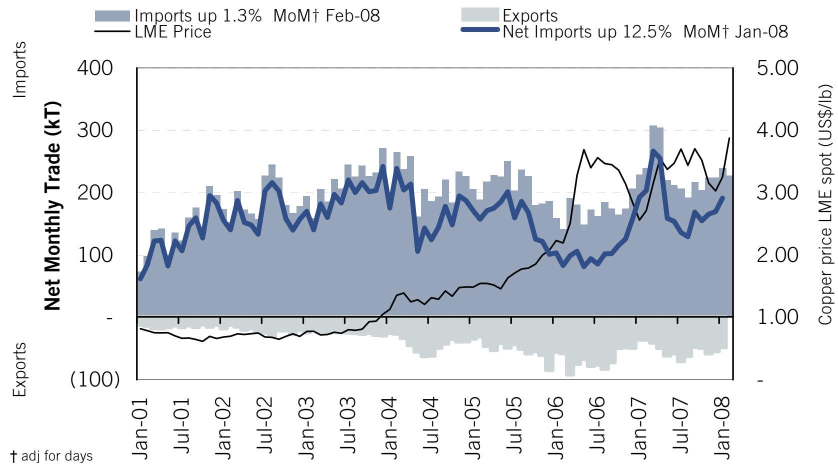
- **Chinese restocking/destocking -** Chinese imports fell during much of 2007 as fabricators drew down inventory. However, restocking commenced late 2007 and continued in the first two months of 2008.

  However, more recently, strong prices over the first three months of the year have resulted in a slowing of Chinese buying.

  Further, the arbitrage discount between LME and SFE prices has again encouraged exports, although this is yet to be seen in the trade data.

Imports rose strongly in early 2008, but have probably slowed as prices rallied.

Figure 16. China's Copper Imports



Gross Imports (kT)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total	YTD
2003	195	159	206	186	221	207	245	226	243	227	232	272	**2,618**	353
2004	201	266	238	259	161	206	187	194	221	184	234	226	**2,576**	466
2005	206	189	218	228	226	250	203	237	226	180	183	186	**2,532**	394
2006	159	141	191	181	149	173	162	185	175	165	175	207	**2,062**	300
2007	229	240	308	305	221	212	207	192	217	204	224	225	**2,782**	469
2008	**240**	**227**												466

Source: China Administration of Customs, Bloomberg, Citi Investment Research

We are structurally positive on copper given the long-term supply challenges from falling grades, political risk and rising capex budgets.

Long-Term Copper: Supply-Side Support

Citi forecasts a supply deficit in 2008/09, turning to a surplus by 2010. Consumption is led by growth in China, as for all the major industrial metals.

We see the biggest risk in our forecasts as supply-side shortages. There is no shortage of large copper deposits. The problem is they tend to be in regions of high political risk, and are thus subject to a great deal of uncertainty.

Figure 17. Supply / Demand Forecasts

mT	2006	2007	2008	2009	2010
Mine Production (Concentrates)	12.5	12.5	13.3	13.9	14.9
Smelter Utilization (%)	83.8%	80.3%	80.0%	80.0%	80.0%
Refined Production Total	17.3	17.7	18.0	18.7	20.7
Consumption	17.1	17.7	18.0	19.1	20.1
Copper Market Surplus / (Deficit)	0.2	0.0	0.0	-0.4	0.6
Stock : Consumption Ratio (wks)	0.0	0.0	0.0	0.0	0.0

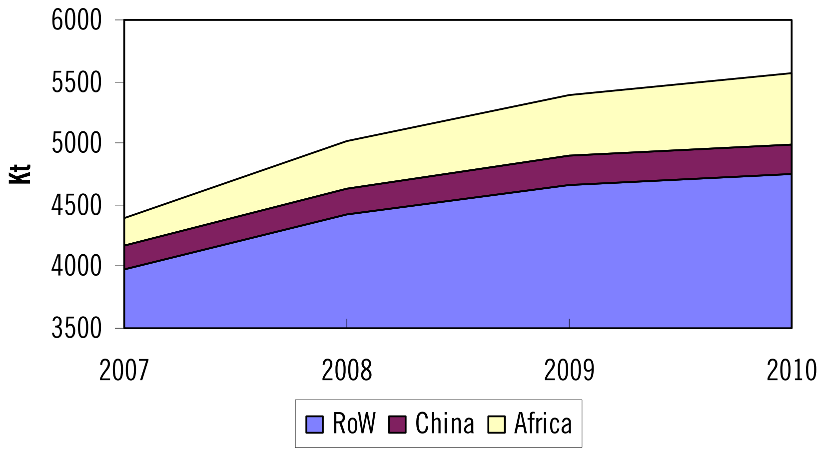
Source: Citi Investment Research

The most pressing supply-side problems are:

- **Disruptions:** We expect supply side issues to continue to provide support for the copper price. Over the last two years a large part of the copper price story has been of supply disruptions and operational disappointments. In 2006, we saw supply disruptions from labor strikes (Escondida) and operational issues (Freeport). In 2007, operational disappointments were the focus caused by delays to expansions and production shortfalls. Similarly, in 2008 we have already seen the copper price heading toward US$8,000/t on the back of production shortfalls in Chile and weather issues in China (and continued robust demand). Power issues in SA and Zambia have also had an impact in 2008.

- **Political risk –** An increasing proportion of new copper supply will come from high political risk regions. Central Africa should add 10% of the expected new supply, and potentially much more. This new supply is looking more tenuous in recent months as both the DRC and Zambia have begun to agitate for a higher share of mining profits. Such actions will clearly discourage investment by Western firms.

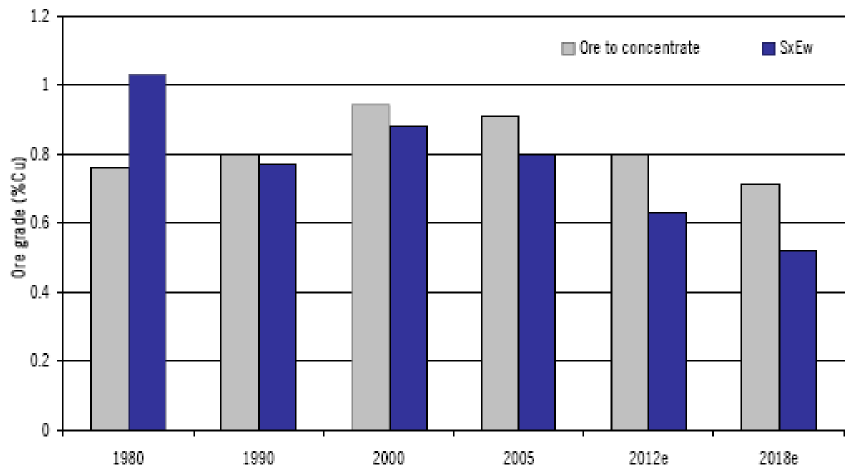
Figure 18. Expansions by Region forecasts



Source: Citi Investment Research

- **Falling ore grades:** Ore grades should begin to decline after increasing over the last few years. But large scale development of high grade reserves in Zambia and the DRC (3-4% grade, 10-20Mt contained) would reverse this trend.

Figure 19. Copper Ore Grades



Source: BrookHunt and Citi Investment Research

- **Power shortages**. Power problems have occurred in several important supply-side regions for copper including China, Zambia, and mostly importantly, Chile. In Chile the power supply problems are driven by drought and reduced imports of gas. The response has entailed voltage reductions and increased diesel power generation. The situation is expected to remain fragile until 2010 when additional generating capacity is due on-stream. But, if precipitation does not increase in 2008 power rationing will be likely. Potential losses of copper production are 4kt for every MW of electricity not available. Companies are responding by building captive diesel power plants.

- **Capex costs:** While operating costs have risen an average of 51%, capex costs have risen in the order of around 45% over the past two years.

Figure 20. Capex costs for new projects

Project	Commodity		Capex 2006est	Capex 2008 est	%Increase	Capacity (ktpa)	US$/t
Olympic Dam Expansion	Copper	Greenfield	4,400	6,500	48%	575	11,304
Resolution	Copper	Greenfield	1,000	1,700	70%	158	10,794
Quellaveco	Copper	Greenfield	1,200	1,744	45%	200	8,720
Los Bronces Expansion	Copper	Brownfield	1,200	1,700	42%	170	10,000
Callahuasi	Copper	Brownfield	2,200	3,200	45%	420	7,619
Oyu Tolgoi	Copper	Greenfield	1,000	1,500	50%	200	7,500
Tenke Fung	Copper	Greenfield	650	900	38%	170	5,294
Prominent Hill	Copper	Greenfield	782	955	22%	104	9,173
Kolwezi	Copper	Greenfield	450	593	32%	70	8,471
Esperanz	Copper	Greenfield	1,100	1,500	36%	195	7,692
Aktogay	Copper	Greenfield	500	1,000	100%	100	10,000

Source: Citi Investment Research, Company Data

Long-Term Price Analysis:

Citi currently have a long-term copper price of 145c/lb and our commodity analyst derives this price by:

- Determining the proportion of current costs which are structural vs cyclical. Normalising for exchange rates, energy costs, TC/RCs and by product credits, we estimate sustainable costs in 2006 to be USc66/lb.
- Projecting long-term costs. We estimate the industry average cash cost in 2015 will be USc80/lb.
- Determining an appropriate long-term margin. We believe there is a trend to long-term margin expansion, driven in part by a steepening cost curve. We have increased our assumption of long-term industry average cash margin to 45%.

Figure 21. Long Term Costs and Prices (USc/lb)

	2004	2006	sustainable component	long term	incr 04-06	% inc sustainable
Cash Cost	48	71	66	80	48%	38%
Margin (%)				45%		
Price				145		

Source: Citi Investment Research

Figure 22. Assumptions

Discount Rate	**8%**
Reserve Mt	370
gross development capex US$	1800
capex/tonne	4.86
grade	1.20%
Copper price Usc/lb	145.00
Cash costs inc by product Usc/lb	80.00

Source: Citi Investment Research

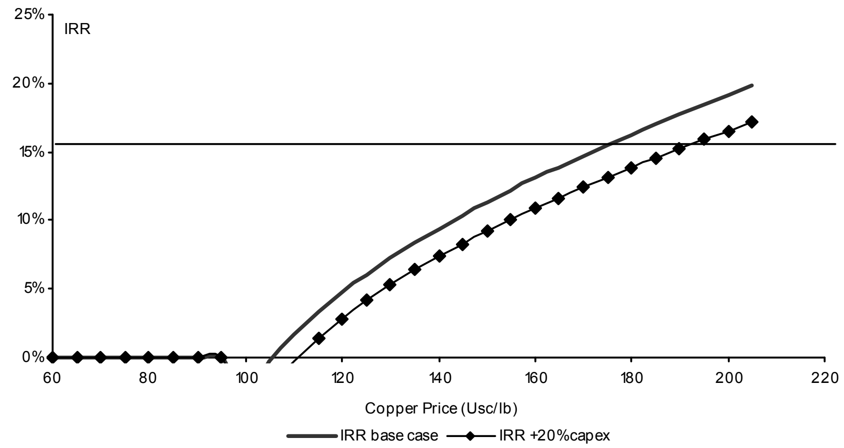
Incentive pricing suggests $2/lb long-term copper, well above Citi's global forecast of $1.45/lb

Long-run incentive prices suggest upside to our forecasts

We have updated a generic copper model for the current capex, head grades and operating costs for Greenfield copper projects. Our assumptions are listed in the Figure on the left.

- With our long-term copper assumption of 145c/lb and operating costs of 80c/lb, our generic copper model calculates an IRR of just 10.4%.
- For a new copper mine to achieve an IRR of 15%, we would require a long-term copper price of 175c/lb, which is 17% above our long-term copper price of 145c/lb.
- Interestingly, if capital costs were to rise a further 20% then a long-term copper price of 190c/lb would be required to generate an IRR of 15%.
- Moreover if a 20% IRR was required for riskier projects and countries then it would require a long-term copper price over 205 c/lb.

Figure 23. Citi Generic Copper mine – IRR versus long-term copper price.



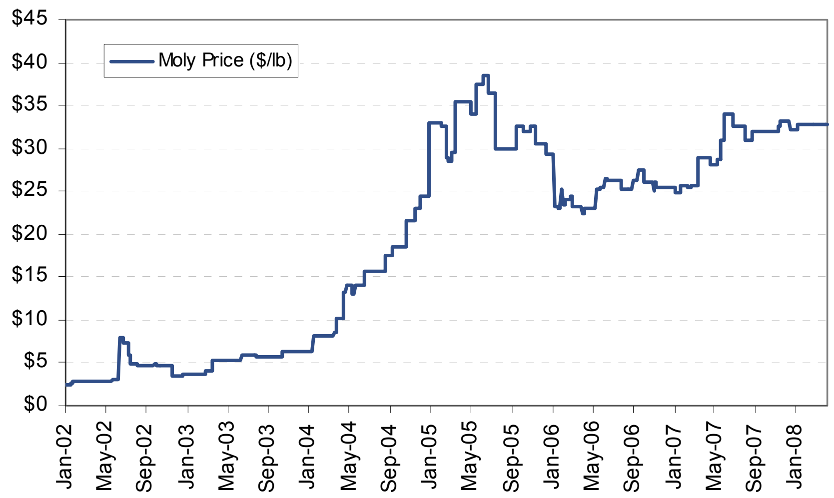
Source: Citi Investment Research

Molybdenum Market Outlook

The molybdenum price is now at nearly 5-10x its historical average of $3-5/lb. Molybdenum's market is tiny and mostly a by-product commodity. Therefore, prices will continue to be volatile and highly sensitive to supply-side changes.

We expect demand from the steel industry to be robust and sustain current prices. New supply should arrive in 2009/10, and this could pull prices down.

Figure 24. Moly Price ($/lb)



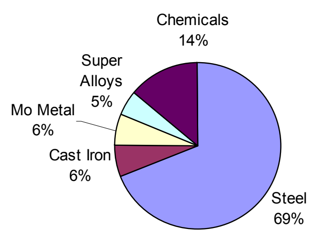
Source: Citi Investment Research

Demand

Molybdenum demand remains robust despite the high price. The steel industry is the key customer for moly – and global steel demand continues to grow strongly, despite rapidly rising prices.

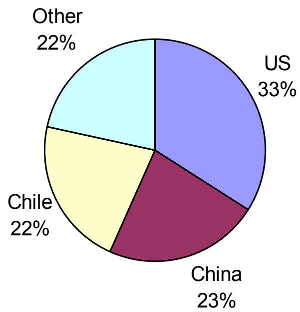
A key support for molybdenum prices is the continued steel and stainless steel demand and substitution of nickel, which will in turn sustain demand for this alloying agent.

Figure 25. Moly Demand (2006)



Source: Citi Investment Research

Figure 26. Moly Production (2006)



Source: Citi Investment Research

Supply

Many mines have been mining molybdenum at the expense of copper in recent years. We believe most of the easy steps to increase production have already been taken and supply should flatten in 2008.

Beyond 2008, projects in Canada and Australia will introduce new supply to the market.

Figure 27. Changes in Moly Supply

	2004	2005	2006	2007	2008E	2009E	2010E	2011E	2012E
USA									
Kennecott	6.8	15.6	16.8	14.9	13.6	13.6	13.6	13.6	13.6
Freeport	26.1	28.3	30.9	30.9	31.7	31.8	39.0	44.5	44.5
Thompson Creek	4.1	5.4	5.0	4.2	7.6	11.8	8.4	8.4	8.4
Montana Resources	2.7	3.5	3.7	3.6	3.6	3.6	3.6	3.6	3.6
Molycorp	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
CANADA									
Endako	5.4	5.9	5.0	4.3	4.2	4.8	4.8	4.8	4.8
Highland Valley	4.6	2.9	1.9	1.8	2.1	2.7	3.6	2.4	2.4
Mt. Hope	-	-	-	-	-	-	2.3	13.0	17.4
MAX					1.4	2.3	2.3	2.3	2.3
Ruby Creek						2.0	5.9	5.9	4.5
NORTH AMERICA	51.1	62.9	64.6	61.2	65.5	74.0	84.9	99.8	102.8
Spinifex Ridge						2.3	10.9	10.9	10.9
AUSTRALIA	**-**	**-**	**-**	**-**	**-**	**2.3**	**10.9**	**10.9**	**10.9**
Malmbjerg						-	-	-	4.5
GREENLAND	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**4.5**
Codelco	32.5	36.6	27.0	27.9	27.2	27.2	27.2	27.2	27.2
Collahusi	-	0.3	3.4	4.5	5.4	5.0	5.5	6.0	6.5
Los Bronces	1.5	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Antamina	3.6	6.7	7.9	6.4	4.9	4.3	4.4	4.7	5.1
SPCC	14.3	14.6	11.6	16.3	17.2	18.5	18.5	18.5	18.5
Antofagasta	5.9	6.8	9.8	11.0	6.8	9.0	10.0	12.0	12.0
Escondida									2.0
Cerro Verde	-	-	-	0.7	1.9	3.6	3.6	3.8	3.8
Alumbrera				0.5	2.0	2.0	2.0	2.0	2.0
CENTRAL & SOUTH AMERICA	**57.8**	**66.8**	**61.4**	**69.0**	**67.2**	**71.4**	**73.0**	**76.0**	**78.9**
China Moly	4.1	5.0	7.3	12.2	15.4	16.8	12.7	11.3	15.0
Other	26.9	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0
CHINA	**31.0**	**35.0**	**37.3**	**42.2**	**45.4**	**46.8**	**42.7**	**41.3**	**45.0**
TOTAL	**139.9**	**164.7**	**163.3**	**172.4**	**178.1**	**194.4**	**211.5**	**228.0**	**242.1**
Change		17.7%	-0.8%	5.6%	3.3%	9.1%	8.8%	7.8%	6.2%

Source: Citi Investment Research

Supply: China

China is one of the world's largest producers of molybdenum and has a significant influence on the market through production controls and export volumes. Two recent events have significantly boosted the moly price:

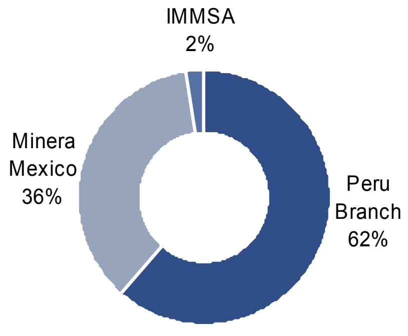
- 2005: China shuts down of small scale and unsafe mines causing a spike in the moly price to nearly $40/lb.

- 2007: China increases export duties and introduced export quotas and licensing was introduced.

Company Description

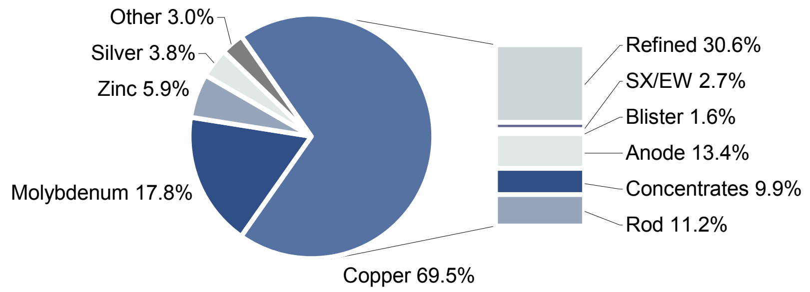
Southern Copper Corporation (NYSE: PCU) is the worlds seventh largest copper producer and the largest publicly traded copper producer by reserves. Its cash costs are the lowest of any major copper mining company, driven by large-scale open pit mines, high by-product credits and sizeable SX/EW production capacity.

Figure 28. 2007 Revenues by Segment



Source: Citi Investment Research

Figure 29. 2007 Revenues by Metal / Copper Product

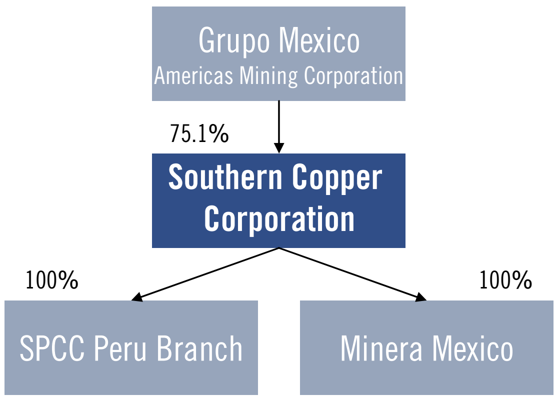


Source: Company Reports

Corporate / Shareholding Structure

Southern Copper is 75.1% owned by Grupo Mexico through a subsidiary holding company called Americas Mining Corporation. Operationally, PCU is divided into SPCC Peru Branch (Peru Division) which operates mining and refining activities in Peru, and Minera Mexico (Mexico Division) which operates mining and refining activities in Mexico including IMMSA.

Figure 30. GMexico/Southern Copper – Simplified Corporate Structure



Source: Company Reports

Shares Structure - Southern Copper

Southern Copper has 167,207,640 voting common shares outstanding; there are no preemptive or subscription rights, and there are no other voting share classes. Each share has one equal vote in matters relating to shareholder action.

GMexico owns 75.1% of PCU's voting shares. The remaining voting shares are publicly held.

Profit sharing "Investment Shares" representing a claim on the Peru Branch´s earnings trade on the Lima Stock Exchange. These shares are non-voting, and may be acquired by employees and private investors, domestic & foreign.

Mining Operations - Facilities

Southern Copper's mining and production facilities are located throughout Mexico and Peru; its production geography is split roughly 50:50 between both countries.

In Mexico (Minera Mexico) the company operates the Cananea and La Caridad open pit mines, several poly–metallic underground mines (IMMSA), and smelting and refining facilities. In Peru (SPCC Peru Branch) the company operates the Toquepala and Cuajone open pit mines, as well as a smelting and refining facility at Ilo.

Besides copper, the company also produces and sells molybdenum & lead concentrates, refined zinc, silver and gold.

In 2007 PCU mined 592 kt of and sold 604kt of copper, out of a nominal capacity of approximately 710 kt. The reduction from nominal capacity was due a prolonged strike at its Cananea and smaller Taxco and San Martin facilities.

Figure 31. Southern Copper, 2007 Copper Production

2007 Copper Production	Mexico			Peru			
Metric Tons	La Caridad	Cananea	IMMSA	Toquepala	Cuajone	Ilo	Total
Mined							
Concentrates	102	64	9	141	182		498
SX/EW	23	35		37			94
Total							592
Smelted							
Anodes	203					232	435
Blister			21			9	30
Total							465
Refined							
Cathodes	173					178	351
SX/EW	23	35		40			98
Total							449
Rod	97						97
Sales							**604**

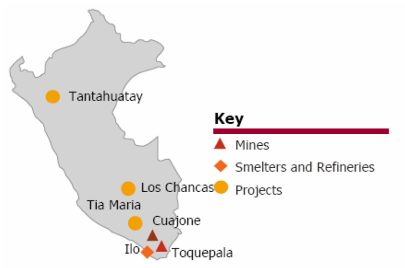
Source: Company Reports

SPCC Peru

Toquepala. Toquepala has a conventional ore deposit with a regular copper grade distribution, except that it contains larger amounts of copper oxides than Cuajone. Therefore and SX/EW SX/EW plant operates there, in addition to a concentrator. Toquepala also contains large amounts of molybdenum, making it among the world's lowest cash cost copper mines.

Facilities at Toquepala include an open pit mine, a concentrator with a milling capacity of 60,000 tons per day, and an SX/EW plant with an annual capacity of 56,000 tons of copper cathode. Toquepala's concentrates are transported via railroad to Ilo for smelting and refining.

Figure 32. Southern Copper - SPCC Peru



Source: Company Reports

Figure 33. Minera Mexico - Operations

Source: Company Reports

Cuajone. Like Toquepala, Cuajone's deposits also contain large amounts of molybdenum. It is an open pit mine, and has a concentrator with a milling capacity of 87,000 tons per day. Concentrates are sent via rail to Ilo for smelting and refining.

Leached copper in solution is sent to Toquepala's SX/EW through a pipeline that follows the Cuajone-Toquepala railway.

Ilo. Ilo is the company's principle smelting and refining complex in Peru. The smelter has a nominal installed capacity of 1,131.5 thousand tons of concentrates per year, exceeding the refinery's input capacity of 280,000 tons of anodes per year; excess anode and blister production is sold to third parties. Gold, silver and commercial grade selenium are recovered from the smelter's anodic slimes at the precious metals refinery. A nearby port facility run by the company receives supplies and ships finished products.

Minera Mexico

Cananea. Mexico's largest mine, and the world's fourth largest copper mine in terms of reserves. Its ore bodies have been of consistent quality, with ore grades improving at deeper dig levels. At current production levels, Cananea could be run for approximately one hundred years. Production expansions are contemplated, but on hold pending the resolution of labor issues.

Facilities include a concentrator with a milling capacity of 76,700 tons of material per day. On site leaching and two SX/EW plants have a combined capacity of 54,750 tons of copper cathode per year. Concentrates are shipped to the La Caridad smelter/refinery complex.

La Caridad. Mexico's second largest mine. Unlike Cananea, its concentrates have a high content of molybdenum, although not as much as those found in the company's Peruvian mines. The company's main Mexican smelting and refining plants operate at La Caridad.

Facilities include a concentrator with a milling capacity of 90,000 tons of ore per day, a smelter and a copper refinery with annual installed capacity of 300,000 cathodes. The SX/EW plant produces up to 21,900 cathodes per year. La Caridad also operates a precious metals refinery, a copper rod plant, a lime plant and two sulfuric acid plants.

IMMSA Underground Mines. PCU's underground poly-metallic mines are Charcas, Santa Barbara, San Martin, Santa Eulalia and Taxco. Copper production from these mines amounts to approximately 2% of Southern Copper's total. The company's zinc and silver comes predominantly from these mines. Small quantities of gold and lead are obtained.

IMMSA's copper and zinc smelting and refining facilities are located in San Luis Potosi. Lead concentrates are sold to 3rd parties.

Southern Copper announced that it plans to shut down San Martin and Taxco. Combined, these mines account for approximately 0.5% of total company copper production.

Reserves

Southern copper has the largest copper reserves of any publicly traded copper mining company and trails only Codelco which is owned by the Chilean government.

The following table shows PCU's proven and probable reserves at a "current" price of $2.66/lb, as defined by SEC reserve reporting guidance. Also included are reserve estimations at price sensitivities of +/- 20% the "current" price, and reserves stated at PCU's long term planning price of $1.20/lb.

Figure 34. Proven and Probable Copper Reserves

SCC Mineral Reserves	Peru Open Pit		Mexico Open Pit		Total Open	Mexico	Price Sensitivity	
millions tons	Cuajone	Toquepala	Cananea	La Caridad	Pit	U/ground	+20%	-20%
Mineral Reserves								
Sulfide ore reserves	2,404	4,373	6,267	3,902	16,946	45	18,268	14,429
Average grade:								
Copper	0.52%	0.44%	0.39%	0.23%	0.39%	0.46%	0.37%	0.42%
Molybdenum	0.02%	0.02%		0.03%	0.02%		0.02%	0.02%
Zinc						3.08%		
SX/EW Material								
Reserves in stock	21	941	705	513	2,179		2,179	2,198
Average copper grade	0.48%	0.14%	0.13%	0.25%	0.17%		0.17%	0.17%
Copper Reserves	**12.6**	**20.3**	**27.0**	**9.8**	**69.7**	**0.2**	**70.8**	**67.1**
Production Capacity (kt)	187	243	131	127	688			
Years of Production	**68**	**83**	**206**	**77**	**101**			

Source: Company Reports

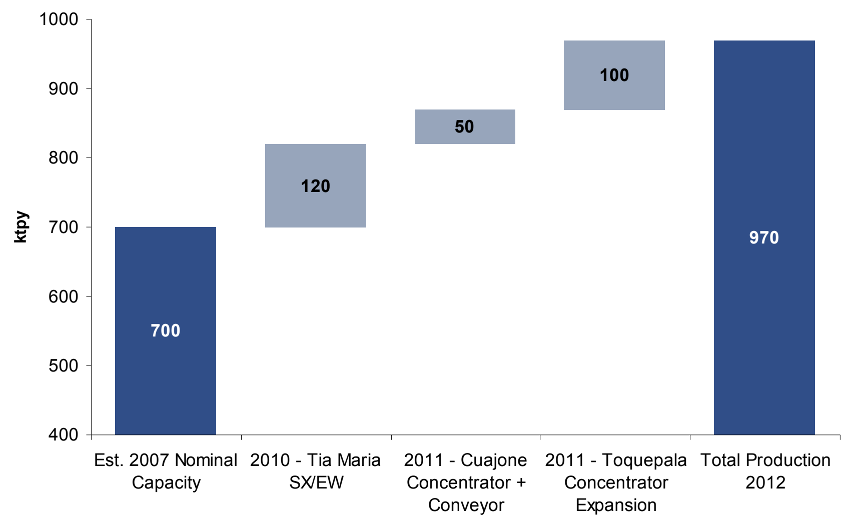
Mining Operations - Expansion Plans

Southern Copper's growth plans include expansions to existing facilities and the development of new mines in both Mexico and Peru.

1st Generation: Southern Copper is expected to spend $2,108 million in Peru over the next 3 years to expand production and develop its Tia Maria project. The expansion is expected to increase overall copper production by 270,000 to a nominal capacity of 970,000 tons of refined copper by 2011. Expansions will include a new concentrator and crusher in Cuajone, an expansion to its Toquepala concentrator, and the development of the Tia Maria copper deposit:

- **Tia Maria.** Development of this new mine is expected to begin in 2008. Located in southern Peru, Tia Maria contains 638 million tons of copper-gold porphyry mineral with an average copper ore grade of 0.39%. The company expects to produce 120,000 tons/year of SX/EW copper beginning in 2010. The estimated mine life is 19 years. Cash costs are estimated to be very low at $0.60/lb.

Figure 35. Southern Copper 1st Generation Production Expansion Profile



Source: Citi Investment Research

2nd / 3rd Generation: Southern Copper has plans to expand Mexican operations by 226,000 tons, but these are on hold pending the definitive resolution of labor issues in Mexico.

The company also has possible new mines and Los Chancas and El Arco which are under feasibility study.

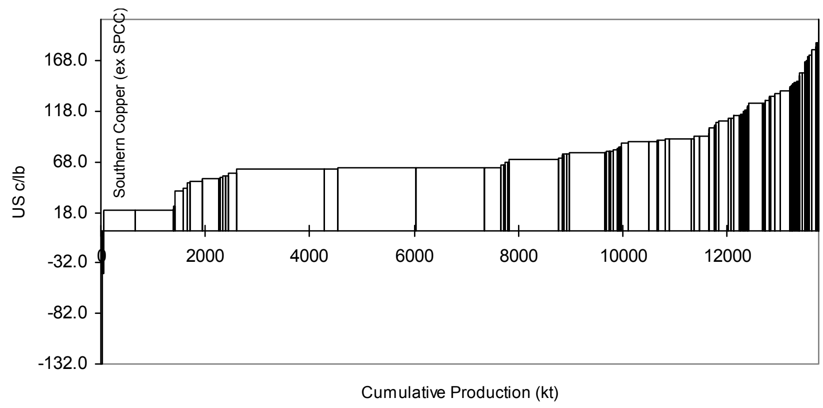
- **Los Chancas.** Also in southern Peru, this site is under feasibility study. Initial studies have indicated 355 million tons of mineral with average ore grades of 0.62% copper, 0.05% molybdenum and 0.039 grams of gold per ton. At a 53,000 ton/year production rate, the expected mine life would be about 35 years. This project, if developed would begin production sometime in 2012-13.

- **El Arco.** El Arco is located in Baja California, Mexico. Preliminary site investigations indicate a mineral deposit of 846 million tons of copper sulfide with average copper grades of 0.51%, 0.14 grams of gold per ton, and 170 million tons of leachable material with average grades of 0.56%. El Arco's development still depends on the availability of water and energy resources, as well as transport. If developed, we would not expect this project to begin production until 2013.

Mining Operations - Costs

Southern Copper has the lowest C1 cash operating costs of any major copper mining company in the world. Key advantages include high by-product credits (such as molybdenum), large-scale open pit mines and substantial SX/EW production capacity.

Figure 36. Global Copper Cost Curve



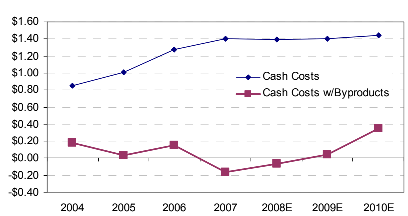
Source: BrookHunt

Its copper cash costs including by products in 2007 were *negative* $0.176 per lb of copper produced, and have been declining due to high molybdenum prices. Excluding by-products, cash costs for 2007 were $1.401 per lb of copper and have been increasing substantially for the last several years (as for all copper producers) as producer cost inflation increases.

While PCU's C1 cash costs should remain below the industry average well into the future, the main takeaway is that PCU's costs of production are highly leveraged on the price of molybdenum and its production levels. A drop in molybdenum's price will adversely affect PCU's cash costs. Moreover, cash costs excluding by-products have been increasing for all copper producers.

We forecast the price of molybdenum (which is primarily responsible for PCU's low cash costs) to remain high into 2009 ($30/lb from $32/lb in 2008).

Figure 37. PCU's Cash Costs ($/lb)



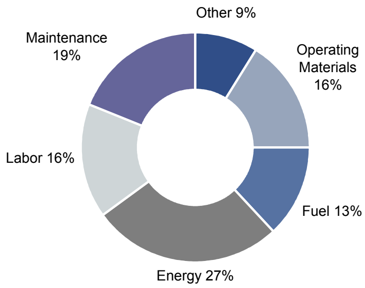
Source: Citi Investment Research

Other Cost Considerations

Energy and Fuel account for approximately 27% & 13% respectively, of Southern Copper's costs structure. This is especially significant given the steady increases in electricity and oil prices in recent years, and the expectation of continued increases. Southern Copper has stated that it can no longer offset rising energy prices with efficiency gains alone; further energy price increases may erode margins.

Labor accounts for approximately 16% of costs. In Peru, PCU has a 6 year contract with 5 out of 8 unions. The remaining 3 unions have 3 year contracts. In Mexico, the company has contract terms of 2 years.

Figure 38. Mining Costs



Source: Company Reports

With the increase in commodity prices and higher net incomes, mining companies worldwide have come under pressure from mining unions to increase wages and profit sharing. In declining commodity price environments negotiating lower wages is always difficult, such that previous salary gains make labor costs a structurally high part of a mining company's costs. We expect copper prices to remain high into 2010, but long term projections are for a decrease, which will eventually make labor costs proportionately high.

Southern Copper's key cost advantages include:

- Lower cost SX/EW refining accounts for 19% of production versus more expensive and energy intensive smelting/refining. SX/EW production is expected to increase to 25% of production by 2011.
- High molybdenum/by-product cash credits resulting in copper cash costs amongst the lowest in the copper mining industry.

Key downside cost considerations include:

- Producer Cost Inflation – The current commodities super cycle has created demand for capital investment and expansion, raising the price of equipment, parts and labor. This situation can be expected to continue as mining companies invest heavily in the coming years to expand production.
- Higher energy costs.

Mining Operations - Labor

Southern Copper has had significant labor problems in recent years, especially in Mexico, due to sour relations with a combative mining union. In general, rising profits thanks to higher metal prices are also contributing to labor tensions as workers in both Mexico and Peru demand higher wages and profit sharing.

As of December 31 2007, approximately 72% of Southern Copper's workforce is unionized (68% in Peru and 74% in Mexico).

Labor Issues in Mexico. In August of 2007, a major strike was held at Cananea entirely shutting down production, costing the company over $420 million. Thus far, 8 out of 11 worker's sections have abandoned the union responsible for the strike and returned to work. To date, Cananea has still not resumed normal production levels, and it may not do so until mid 2008.

Labor relations in Mexico may improve over the near term, as many workers from both Cananea and La Caridad (which suffered a crippling strike in 2006) have abandoned the combative mining union responsible for recent strikes.

Nevertheless labor laws in Mexico continue to be opaque and highly inflexible, as evidenced by the sluggish fashion in which the Mexican legal system has dealt with the strike. This imposes a significant potential cost on Southern Copper and represents a risk that future strikes may also lengthy and costly.

Labor Issues in Peru. Peru by contrast has a significantly more flexible labor system. Strikes there have tended to be frequent but short lived, because mining companies are able to hire replacement workers if a strike has been declared illegal which is usually a matter that is quickly ruled on (in contrast to Mexico).

Recent strikes in Peru have not affected production to the same extent that they affect production in Mexico. The last major strikes held at PCU's Peruvian operations were from unions representing Ilo, Toquepala and Cuajone workers, which were negotiating new contracts. The strikes lasted for approximately two weeks; overall production was barely affected thanks to the company's contingency plans.

Management

Southern Copper Corp is managed by a Board of Directors and Senior Management. The Boards set overall company goals and objectives, and Management is responsible for the implementation of the goals and the companies' day to day management.

We believe that Southern Copper's management are competent and have sufficient experience in mining to effectively represent the interests of all stakeholders.

Specific Issues

Grupo Mexico, a holding company incorporated in Mexico, controls Southern Copper and both companies' boards and management are tightly integrated. As a controlled company, Southern Copper is subject to fewer requirements for board independence. Southern Copper has 5 independent directors out of a total of 14 board directors.

Because Southern Copper is a US company and subject to US laws, we do not believe that Grupo Mexico's management would take actions that would run contrary to the protections afforded to investors pursuant to US market regulations.

Nonetheless, Grupo Mexico and by extension Southern Copper are controlled by a single family whose interests and actions may run contrary to those of minority shareholders, even if those actions are in full compliance with US law.

Board of Directors

As of the end of 2007, Southern Copper's board was composed of 14 members, 5 of which are independent.

- **Germán Larrea. Board Chairman.** Grupo Mexico director since 1981; also a member of the Boards of Banamex (Citigroup) SA de CV, and Televisa SAB de CV. Mr. Larrea directly or indirectly controls 65% of GMexico's shares.

- **Oscar González.** Director, President and CEO of Southern Copper and also a Grupo Mexico Director. Mr. González has considerable mining experience with Grupo Mexico.

- **Xavier Garcia de Quevedo.** Director, President & CEO of Southern Copper Minera Mexico, & COO of Southern Copper.

- **Directors:** Genaro Larrea (also a Grupo Mexico Director), Alfredo Casar (also a Grupo Mexico Director), Armando Ortega (VP Legal & General Counsel of Southern Copper), Juan Rebolledo.

- **Independent Directors:** Emilio Carrillo Gamboa (also a Grupo Mexico Director), Harold S. Handelsman, Luis Miguel Palomino, Gilberto Perezalonso, Carlos Ruiz.

Management

Besides Messrs Larrea, González, Garcia de Quevedo and Ortega (described above), Southern Copper management also comprises of the following individuals:

- Genaro Guerrero. VP Finance and CFO.
- José Chirinos. Comptroller.

Many of Southern Copper's directors and management have spent considerable time at Grupo Mexico or Southern Copper, and have extensive knowledge of the mining business. In addition, several key directors are leading business and legal figures in Mexico, with extensive experience in international business and law.

Copper Overview

The Copper Process

Copper deposits are often found with other metals, commonly gold, lead, zinc and nickel, and are mostly extracted from large open pit mines. Underground mining of copper usually involves block caving (see the Mining Methods section for further details). Copper can be found in many forms, however, commercially viable copper is found either as sulfide ores (primary ores), or as oxide ores (secondary ores). Sulfide ores formed when molten solution flowed into the earth's crust as a result of volcanic activity. Oxide ores are found near the surface and are formed from the oxidation of sulfide ores.

The earth's crust contains an average of 60 ppm of copper, although estimates vary. For commercial exploitation a grade in excess of 0.5% is usually required and a typical grade is 2% for underground and 0.5-1.0% for open pit. The production method is dependent on the ore type; sulfide ores are beneficiated in floatation cells whereas oxide ores are generally leached.

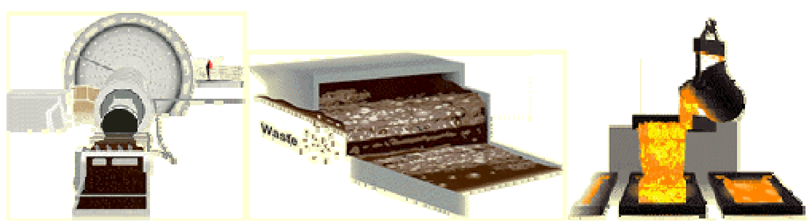
Copper Sulfide Ores (Concentrates)

The copper ore is crushed and ground into a fine powder and sent to a floatation machine for concentration. At the concentration stage the ore is mixed with a collector chemical and introduced to a water bath. Copper sulfides form as a froth at the surface and are skimmed off. The dried froth contains between 20-40% copper and can be traded as an intermediate product in its own right, known as copper concentrate.

The copper concentrate is then smelted to form copper matte, that contains c.70% copper, which is then converted to blister that is c.98% pure copper by blowing hot air through the molten matte.

Figure 39. Copper Production

Mill Crushing Plant **Mill Concentrator** **Smelter**

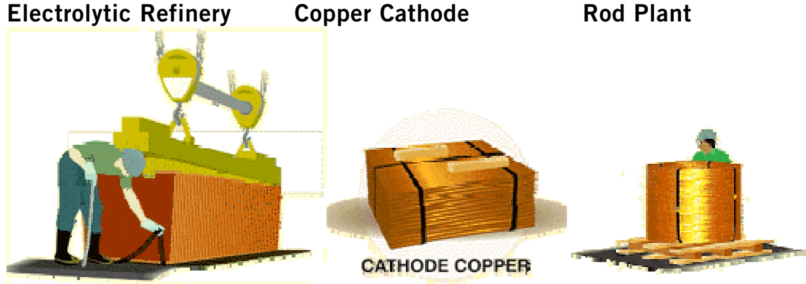


Source: Company Reports

Electrolytic refining is then used to produce copper cathode that is 99.99% pure copper. Copper cathode can be sold directly to customers or spun into coils at a rod plant.

Figure 40. Copper Production

Electrolytic Refinery **Copper Cathode** **Rod Plant**

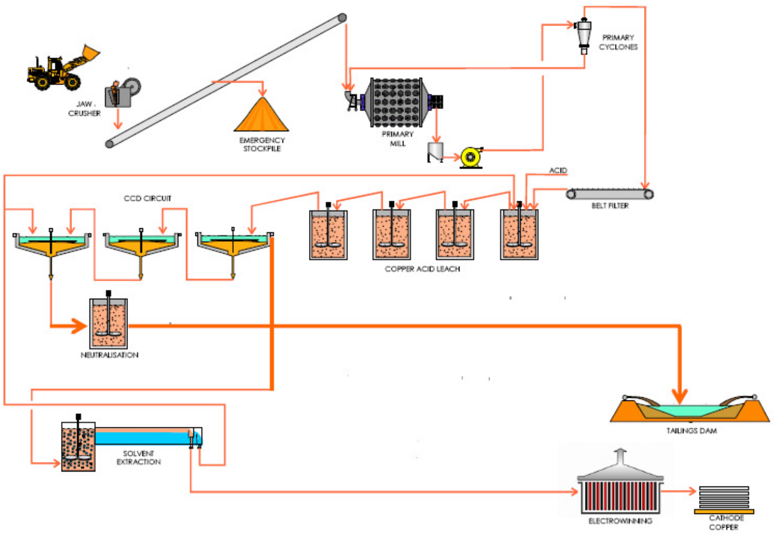


Source: Company Reports

Copper Oxide Ores (SXEW)

Sulphuric acid is used to dissolve the copper in either a heap leach or dump leach process (where the crushed ore is piled in a heap and irrigated with the leaching solution). The dissolved copper solution is collected and transferred to a solvent extraction plant where an organic extractant removes the copper from the solution. The resulting electrolyte solution is transferred to the electrolytic cells for recovery as copper plates (cathodes). This process is known as Solvent Extractrion Electrowinning (SXEW):

Figure 41. Flow Chart SXEW Circuit

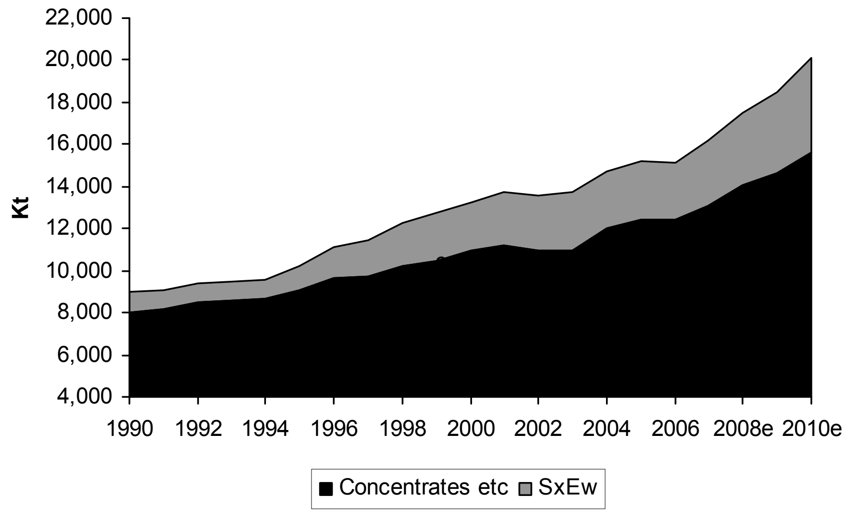


Source: CRU, Brook Hunt

Concentrate vs. SXEW

Concentrate is the dominant source of copper; however, we expect the share of SXEW to increase from 18% to 22% by 2010.

Figure 42. Concentrate and SXEW Supply



Source: Citi Investment Research, Brook Hunt

The table that follows summarizes C1 operating costs for both SXEW and concentrate mines. Excluding by-product credits, SXEW C1 costs in 2006 of $1,625/t were 21% lower than concentrate costs. However, including by-product credits, concentrate C1 costs of $1,223/t were 25% lower than SXEW costs. There are no valuable by-products (e.g. gold and nickel) in oxide ores as they have been eroded away.

Figure 43. 2006 C1 Costs – Concentrate vs. SXEW

	C1 Cost	C1 cost excluding by-products
Concentrate	1,223	2,047
SXEW	1,625	1,625
Total	1,284	1,984

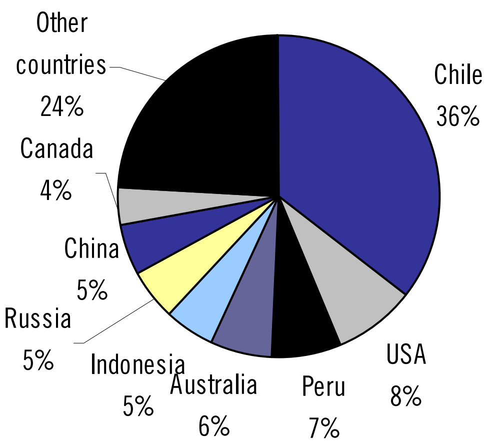
Source: Brook Hunt

Copper Supply

Production and Reserves

Copper is found throughout the world; most significantly in South America where close to half of the world's copper is currently produced. Known reserves of high grade copper are close to 1 billion tonnes and, at the present rate of production, will be depleted in approximately 62 years (ignoring potential new deposits and recycling of scrap). Chile is by far the largest copper producer in the world, accounting for approximately 35% of global production in 2006, followed by the US at 8%.

Figure 44. 2006 Global Copper Production by Country



Source: Brook Hunt, Citi Investment Research

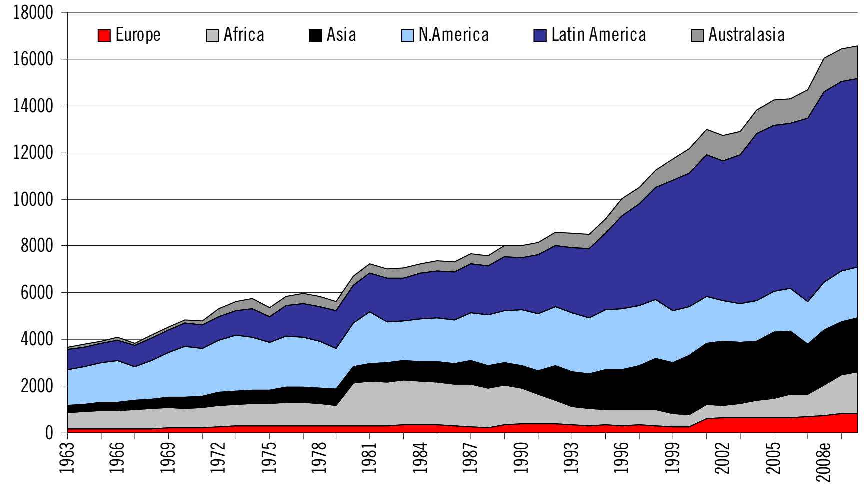
Figure 45. Global Copper Production and Reserves

	Reserves Copper (kt)	2006 Copper Production (kt)	Mine Life
Chile	360,000	5,351	67
US	70,000	1,223	57
China	63,000	736	86
Peru	60,000	1,067	56
Poland	48,000	517	93
Australia	43,000	884	49
Mexico	40,000	331	121
Indonesia	38,000	784	48
Zambia	35,000	534	66
Russia	30,000	779	38
Canada	20,000	608	33
Kazakhstan	20,000	484	41
Other countries	110,000	1,777	62
Total	937,000	15,076	62

Source: Citi Investment Research, US Geological Survey

The development of Chile as a major new copper province in the 1970s led to South America emerging as the dominant copper producer in the 1990s. In the 1980s, Africa was also a significant copper producer (c.1.8 Mt per annum / 20-25% of total production), however, due to political unrest in central Africa, production decreased significantly at the end of the 1980s / 1990s reaching a low of 0.5 Mt (4% of total) in 2000. However, the Zambian / DRC copper belt is reemerging and production is increasing; 2006 production was 1 Mt and we expect production to return to 1.8 Mt by 2010.

Figure 46. Mine Supply Growth



Source: WBMS, Brook Hunt, Citi Investment Research

Copper Mines

Five of the ten largest copper mines by production in 2006 are in Chile:

Figure 47. Top 10 Copper Mines 2006

Rank	Mine	Country	Ownership	2006 Production (kt)
1	Escondida	Chile	BHPB 60%, Rio Tinto 30%, Others 10%	1,094
2	PT Freeport Indonesia	Indonesia	Freeport 84%, Gov of Indonesia 9%, Rio Tinto 7%	595
3	Chuquicamata	Chile	Codelco 100%	506
4	KGHM Polish Copper	Poland	KGHM Polska 100%	478
5	El Teniente	Chile	Codelco 100%	408
6	Norilsk	Russia	Norilsk 100%	401
7	Collahuasi	Chile	Anglo 44%, Xstrata 44%, Others 12%	377
8	Antamina	Peru	BHPB 34%, Teck Cominco 23%, Xstrata 17%, Others 26%	368
9	Morenci SxEw	US	Freeport 85%, Sumitomo 15%	355
10	Los Pelambres	Chile	Anto 60%, Nippon 15%, Others 25%	308

Source: Citi Investment Research, Brook Hunt

Copper Mining Companies

Chilean state copper miner Codelco is the world's largest copper producer:

Figure 48. Estimated Top 10 Copper Producers 2007

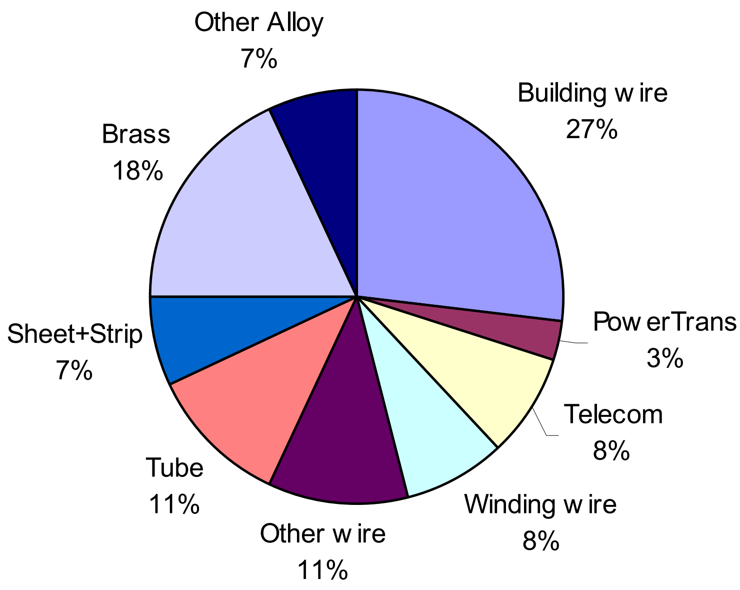
Company	Production (kt)
Codelco	1,677
F-McM Copper & Gold	1,528
BHP Billiton	1,381
Xstrata AG	889
Rio Tinto	736
Anglo American plc	661
Grupo Mexico	530
KGHM Polska Miedz	492
RAO Norilsk	417
Kazakhmys	399

Source: Brook Hunt

Applications

Copper use dates back to ancient civilizations over 5,000 years ago and was widely used by the Greeks and Romans. Copper is now one of the major industrial metals, ranking only behind iron and aluminium in terms of consumption by mass.

Figure 49. 2006 Consumption by End Use



Source: Citi Investment Research

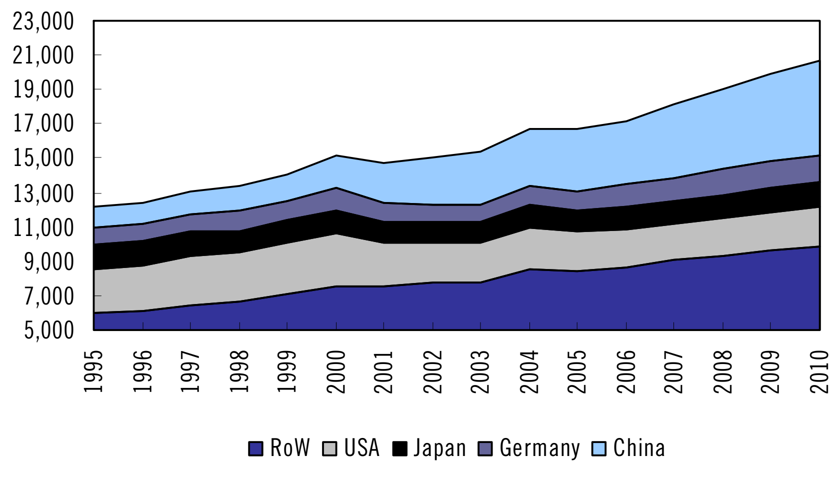
Copper's malleability, thermal and electrical conductivity (copper has the second highest electrical conductivity of all the metals behind silver), and its resistance to corrosion, give it wide-ranging uses. Consumption can be divided into three main product groups:

- Copper wire rod: This is the largest group, accounting for c.57% of consumption in 2006, encompassing building wire, power transmission, telecommunications, and winding wire.
- Copper products: Copper tube is the largest of the copper product markets. It is used in plumbing, heating and air conditioning systems.
- Copper alloy products: Bronze and brass are two of the most well-known copper alloys, both used for building fixtures and fittings. Copper sheet and strip is used for roofing, gutters and drain pipes. Copper alloys are also used in coinage.

Consumption

Chinese demand has grown rapidly since the mid-1990s, more than trebling between 1995 and 2006 to 3.4 Mt. China is now the world's largest consumer, having overtaken the US, accounting for c.21% of world consumption in 2006. We expect China consumption to continue to grow at c.12% and global consumption growth of 4.5%.

Figure 50. Global Copper Consumption – 1995 to 2010e



Source: Brook Hunt, Citi Investment Research

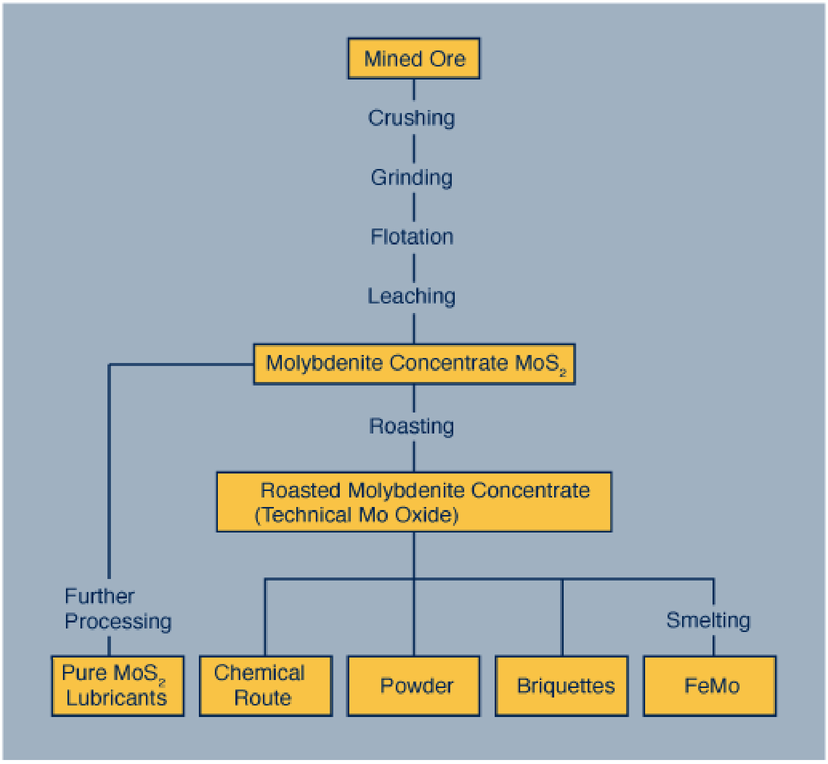
In contrast, US demand has declined from 3.0 Mt in 2000 to c. 2.2 Mt in 2006. US copper demand is closely linked to the housing cycle and demand is expected to be flat or marginally negative in 2008 due to lackluster demand from the construction and autos sectors.

Molybdenum Overview

The Molybdenum Process

Molybdenum has a concentration of 1-2 ppm in the earth's crust. The only commercial source of molybdenum is molybdenite (a metal sulfide). Ore grades range from 0.01-0.25%. Molybdenum is mostly produced as a by-product of copper but is also produced in large-scale (due to the relatively low grade of most Molybdenum ores) primary projects.

Figure 51. The Molybdenum Process



Source: International Molybdenum Association

- The molybdenum ore is passed through a series of crushers and rotating balls or rod mills to break it into tiny particles less than a millimetre in diameter. The ore is the concentrated in aerated floatation tanks.

- Acid is used in the leaching process to remove impurities such as copper and lead.

- Roasting converts the sulfide concentrate to molybdic oxide by forcing air through the system at temperatures of approximately 650 C. This 10-hour process produces technical grade molybdic oxide which contains a minimum of 57% molybdenum.

- Further processing to increase the Molybdenum content can take place, depending on the intended end-use.

Molydenum Supply and Demand

Production and Reserves by Geography

The three largest molybdenum producers, US, China and Chile, together account for close to 80% of global production and approximately 85% of global reserves. As the Molybdenum market is tiny compared to other base metals and because it is largely produced as a by-product, prices are volatile and tend to be highly sensitive to supply-side changes.

Figure 52. Molybdenum Reserves, 2006 Production and Mine Life

	Molybdenum Reserves (kt)	2006 Molybdenum Production (kt)	Mine Life
China	8,300,000	41,000	202
US	5,400,000	60,500	89
Chile	2,500,000	38,700	65
Canada	910,000	8,460	108
Armenia	400,000	2,750	145
Russia	360,000	3,000	120
Mexico	230,000	2,500	92
Peru	230,000	17,500	13
Iran	140,000	2,200	64
Mongolia	50,000	1,200	42
RoW	480,000	1,190	403
Total	19,000,000	179,000	106

Source: US Geological Survey

Mining Companies

Phelps Dodge of the US and Codelco of Chile, both two of the world's largest copper producers, are the two largest molybdenum producers in the world:

Figure 53. Estimated Top 10 Molybdenum Producers 2007

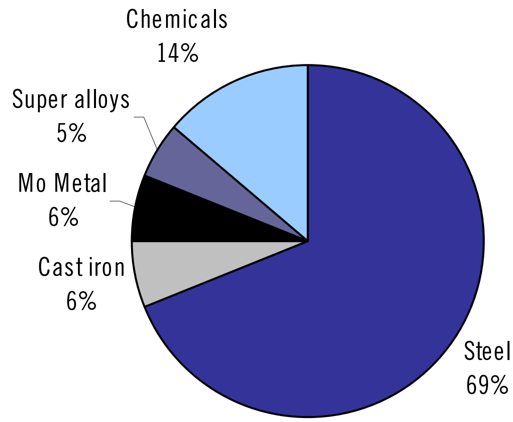
Company	Production (kt)
Phelps Dodge	32.9
Codelco	29.5
Kennecott	15.9
SPCC	11.8
Thompson Creek	9.5
Antamina	7.9
Antofagasta	6.8
Endako	5.0
Collahusi	4.5
Montana Resources	3.6

Source: Tex, company reports, Citigroup Investment Research

Applications & Consumption

Molybdenum's primary use is in the production of stainless steel and alloy steels, providing strength and corrosion resistant properties. Different types of stainless steel contain different quantities of molybdenum up to a maximum of 7%. It is also used as a catalyst in the petroleum industry, in paint pigments, flame retardants and light bulb filaments.

Figure 54. Consumption by End-use



Source: IMOA

While there are potential substitutes for Molybdenum, for example vanadium, chromium, columbium and boron in alloy steels, tungsten in tool steels, graphite, tungsten and tantalum for refractory materials in high-temperature furnaces, and chrome-orange, cadmium-red, and organic-orange pigments for dies, they are rarely used mainly due to the availability of molybdenum.

Southern Copper Company

Company description

Southern Copper is one of the largest copper producers in the world, with mines located in Mexico and Peru. The company has the 2nd largest copper reserves of any company, equivalent to 100+ years of production. Revenues in 2007 were split 69% copper, 18% molybdenum, 6% zinc, 4% silver and 3% other. Cash costs are very low driven by large-scale open pit mines, high by-product credits and sizeable SX/EW production.

Investment strategy

We have a Sell (3H) rating on Southern Copper. PCU is a world-class mining company with strong assets. Our Sell recommendation is based on a valuation which is too high, in our view. Key issues include: 1. PCU trades at a significant earnings multiple to its closest copper producing peers, 2. the current share price is assigning a "mid-cycle" multiple to "peak" earnings, 3. modeling suggests the shares are already discounting a bullish outlook of $2/lb long-term copper, 4. we expect the copper price to decline in the near term.

Valuation

Our target price on Southern Copper is $102 per share. We calculate our target price on a 50:50 mix of PE multiples and DCF modeling. We apply a 10x multiple to 2009E EPS for a price of $94 per share. Southern Copper has recently traded between 5-15x EPS and we choose the midpoint of this range, believing this is appropriate for the current position in the copper cycle. Our DCF modeling suggests a value of $91 and we apply a 20% premium for a NAV target of $110.

Risks

We rate Southern Copper a High risk stock. The company operates in historically volatile commodity markets, yet these risks are mitigated by the company's production diversity (with two large mines in both Mexico and Peru) and low operating costs.

Risks that could cause the shares to remain above our target valuation include:

Copper Price: Southern Copper's earnings are highly leveraged to the copper price. Power shortages or other major supply-side disruptions could continue to drive this price to new record highs.

M&A: The Larrea family may decide to sell Southern Copper which would likely result in considerable upside to shareholders.

Energy Costs: Approximately 1/3rd of mining costs are related to energy. A fall in energy costs would cause earnings to be above our estimates.

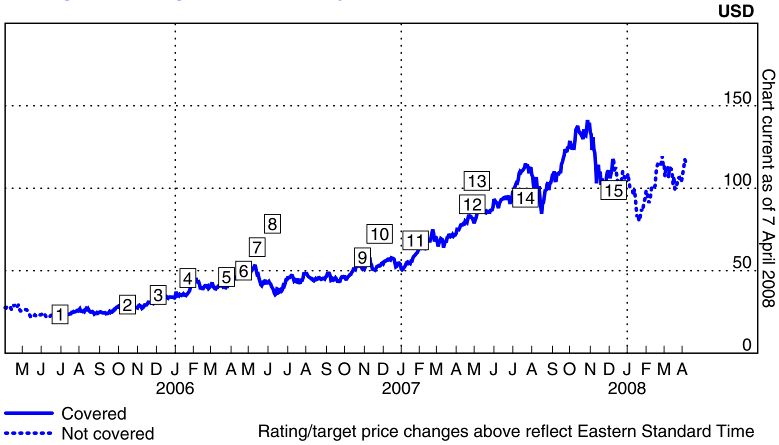
Appendix A-1

Analyst Certification

Each research analyst(s) principally responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst covers in this research report, all of the views expressed in this research report accurately reflect their personal views about those issuer(s) or securities. Each research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this research report.

IMPORTANT DISCLOSURES

Southern Copper Company (PCU)
Ratings and Target Price History - Fundamental Research



#	Date	Rating	Target Price	Closing Price
1:	30 Jun 05	*2H	*48.00	21.42
2:	17 Oct 05	2H	*56.00	26.56
3:	5 Dec 05	2H	*72.00	34.66
4:	24 Jan 06	2H	*78.00	36.36
5:	27 Mar 06	2H	*90.00	40.50
6:	24 Apr 06	2H	*110.00	49.39
7:	15 May 06	*1H	*135.00	47.65
8:	8 Jun 06	*2H	*100.00	39.41
9:	29 Oct 06	2H	*50.00	50.57
10:	27 Nov 06	2H	*56.00	52.85
11:	26 Jan 07	2H	*63.00	59.91
12:	27 Apr 07	2H	63.00	82.27
13:	4 May 07	2H	*86.00	84.16
14:	22 Jul 07	2H	*125.00	115.01
15:	10 Dec 07	Coverage suspended		

*Indicates change.

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Citi Investment Research Ratings Distribution			
Data current as of 31 March 2008	**Buy**	**Hold**	**Sell**
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% of companies in each rating category that are investment banking clients	52%	51%	43%

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