SELECTED INTANGIBLE AND TANGIBLE ASSETS VALUATION

Exhibit A4 – Selection of Appropriate Discount Rate

We estimated a discount rate based on a market participant’s perspective of

NeoPhotonics Russia’s weighted average cost of capital (“WACC”). The WACC is an estimate

of the rate of return on investment required by all investors of capital. The WACC is computed

by calculating the cost of debt and cost of equity. The costs of equity and debt were developed

based on market-derived data and factors relevant to the economy, the industry, and the

Company as of the Valuation Date. Certain data inputs were derived from the observed data of

selected guideline companies. These costs were then weighted in terms of a typical industry

capital structure to arrive at an estimated WACC.The WACC is determined as follows:

FORMULA 2. WACC

WACC = (Wd)(Kd) + (We)(Ke)

Where:

Wd

Kd

We

Ke

–

–

–

–

Share of debt to total capital

After-tax cost of debt

Share of equity to total capital

Cost of equity

Cost of Equity

The cost of equity (Ke), or required return on equity, was estimated using the capital asset pricing

model (“CAPM”). The CAPM may be used to relate the returns equity investors require to the

risk-free return as approximated by government securities. The additional returns or risk premium

required by the market in general can be adjusted by the factor beta, to account for relative risks

for specific industries. The CAPM utilizes the following formula to arrive at an appropriate cost of

equity rate.

FORMULA 3. DISCOUNT RATE CALCULATION

R  R  CRP β  R  R  SP

 efmf

Where:

Re

Rf

CRP

β

Rm-Rf

SP

–

–

–

–

–

–

Required rate of return;

Risk-free rate;

Country Risk Premium;

Beta, a measure of the relationship between industry risk and the aggregate market;

The expected return of the market in excess of the risk free rate;

Size Premium.





Risk-free Rate (Rf)

A proxy of a risk free-rate Rf for investments was considered to be the 10-Year U.S. Treasury

Securities. As of June 30, 2014 they were yielding 2.53%26.

Country Risk Premium (CRP)

Country risk premium for Russian investments was estimated using the market pricing of 10-year

Russia Credit Default Swaps (CDS). As of the valuation date the market price of this contract

amounted to 2.25%27.

Beta

Estimation of the beta coefficient relates to a specific industry’s risk compared to the average

market risk. Essentially, it is a mathematical calculation of the historical reaction of the stock price

of representative companies in an industry, to the changes in the aggregate prices of the stocks

in the market as a whole.

The beta coefficient of 1.14 was indicated by the data provided by Aswath Damodaran 28 for

Telecom Equipment industry.

26

Bloomberg

Bloomberg

http://people.stern.nyu.edu/adamodar/

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27

28

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Exhibit A4 – Selection of Appropriate Discount Rate

Equity Risk Premium

The equity risk premium (“ERP”) is the extra return over the expected yield on risk-free

securities that investors expect to receive from an investment in a diversified portfolio of

common stocks. It can also be thought to measure what investors demand over and

above the risk-free rate for investing in equities as a class or the market price for taking on

average equity risk.

There is no one universally accepted standard for estimating ERP. The methods

used in estimating it can be broadly categorized into one of the two approaches:

the Realized Return, or ex post approach, and the Forward-looking Return, or ex-ante

approach29.

The realized return approach is based on the expectation that history will repeat itself and

such a premium return will again be realized (on average) in the future. Historical market

realized equity premiums since 1926 as reported by Ibbotson Associates’ SBBI Yearbook are

often considered as proxy of ERP.

While one can observe premiums realized over time by referring to historical data,

such calculated premiums serve only as estimates for the expected ERP. Moreover

giving considerations to long-run historical arithmetic average realized returns, many recent

researches conclude that the post-1925 historical arithmetic average of one-year

realized premiums as reported in the SBBI Yearbook results in an expected ERP estimates that

is too high. In most recent update to the study of Roger Ibbotson and Peng Chen reported

in the SBBI Yearbook, Ibbotson Associates determine that the long-term ERP that

could have been expected given the underlying economics was approximately

6.1% on an arithmetic basis for 1926-2011 compared to actual risk premium of 6.6%30.

Research has shown that ERP is cyclical during the business cycle. When the economy is near

or in recession (and reflected in the relatively low prices of stocks), the conditional ERP is more

likely to be at the higher end of the range. When the economy improves (with expectations of

improvement reflected in higher stock prices), the conditional ERP is more likely at the lower end

of the range31.

Comparison of historical risk-free rate and ERP is provided in the chart below.

CHART 9. RISK-FREE RATE VS ERP

Source: American Appraisal

29

30

31

Roger J. Grabowski, “Equity Risk Premium: What is the Current Evidence?” Business Valuatin Digest, 2005

Ibbotson SBBI 2012 Valuation Yerbook

Shannon Pratt and Roger Grabowski, Cost of Capital: Applications and Examples, fourth edition (New York:

John Wiley & Sons, 2010), pages 115, 137

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Exhibit A4 – Selection of Appropriate Discount Rate

In recent years the historical basis of ERP was challenged on the back of the interest rates of

the risk-free asset dynamics. All around globe the US Treasury bonds were considered

as asset, which properties are almost matching the concept of risk-free asset. Therefore,

the US Treasury bonds were used as risk-free asset for the purposes of the relevant

calculation.

In recent years, US risk-free rates have reached levels near historic lows due to the

perceived low risk of US treasuries relative to the sovereign debt of other developed

nations. Additionally, the Federal Reserve and other Central Banks around the world have

undertaken quantitative easing and other efforts to lower interest rates in response to economic

conditions. As a result, the capital asset pricing model (“CAPM”), which utilizes the ERP to

calculate a cost of equity, has implied a below-average cost of equity when the market may have

exhibited higher risk.

American Appraisal32 researched and analyzed various economic and market factors in order to

determine where the current ERP should fall within a range of historical ERP. Analysis was

performed based on historical ERP for two terms 1993 – 2013 and 2003 – 2013.

Research revealed that CBOE volatility index (VIX), Damodaran’s Implied Premium, and

Moody’s Aaa corporate credit spreads demonstrated medium to strong negative correlation with

the historical ERP premiums. In particular the following results were arrived at:

TABLE 13.

Parameter

CBOE Volatility Index (VIX)

Damodaran’s Implied Premium

Moody’s Aaa 20 years corporate credit spreads

CORRELATION OF SUBJECT PARAMETERS AND ERP

1993 – 2013

-0.59

-0.30

-

2003 – 2013

-0.74

-0.49

-0.55

Source: http://www.american-appraisal.com/US/Library/Articles/Equity-Risk-Premium-Quarterly-7.htm

In addition the following economic indicators determining current status of the USA economy

were analyzed. Among the selected factors are these featuring economic cycle and

comprising Consumer sentiment trends, as tracked by the University of Michigan and

USA Real GDP.

With consideration of the above, ERP premium recommended by American Appraisal for the

purposes of calculations in combination with risk-free rate amounted to 6.0%.

32

http://www.american-appraisal.com/US/Library/Articles/Equity-Risk-Premium-Quarterly-7.htm

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Exhibit A4 – Selection of Appropriate Discount Rate

TABLE 14.

EQUITY RISK PREMIUM (“ERP”) STUDY)

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Exhibit A4 – Selection of Appropriate Discount Rate

Size Premium (SP)

The size premium reflects the risks specific to the company due to its size. This premium is also

known as the return in excess of CAPM or “beta-adjusted size premium”. The size premium is

considered as empirically observed correction to the CAPM.

Based on the data provided in "Morningstar, Inc.’s” SBBI (Valuation Edition 2013 Yearbook) size

premium (SP) of 3.81% (corresponding to Micro-Cap group of companies) was used for the

subject valuation.

Based on the above analysis the post-tax cost of equity in U.S. Dollars amounted

to 15.4%.

Cost of Debt

The before-tax cost of debt of 6.8% was selected based on the average interest rate for long-

term USD-denominated loans in Russia as of June, 2014 as indicated by Central Bank of Russia33.

Using the nominal corporate income tax rate of 20%, the after-tax cost of debt was concluded to

be 5.5%.

Capital Structure

Industry leverage of 10.8% as measured by the ratio of net debt to equity was indicated by the

data provided by Aswath Damodara34. This corresponds to the capital structure of 90% equity

and 10% debt, which was assumed in our analaysis.

WACC Conclusion

Based on the preceding analysis of each of the components, the concluded post-tax WACC was

calculated as follows:

Post- tax WACC

post -tax WACC

post-tax WACC

=

=

=

(Wd)(Kd) + (We)(Ke)

10%\* 5.46%+ 90% \* 15.43%

14.46%

The post- tax discount rate was concluded to be 14.46%.

33

34

http://www.cbr.ru/statistics/print.aspx?file=b\_sector/rates\_cr-no-d\_14.htm&pid=procstavnew&sid=ITM\_30164

http://people.stern.nyu.edu/adamodar/

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SELECTED INTANGIBLE AND TANGIBLE ASSETS VALUATION

Exhibit B

Selected Tangible Assets Valuation

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SELECTED INTANGIBLE AND TANGIBLE ASSETS VALUATION

Exhibit B – Illustrative Valuation Example

The exhibit provides illustrative valuation example for separate types of assets.

TABLE 15.

Asset

MACHINERY AND EQUIPMENT

LIGHTWAVE POWER

SENSOR (MODULE)

Machinery and equipment

4

July 2008

CNY 52 700

ASSEMBLY & TESTING

HORIZONTAL FURNACE

Plasma Enhanced

Chemical Vapor

Deposition (PECVD)

Machinery and equipment

1

Not in books

n/a

OPTICAL WAFER

PROCESSING

Market approach

Specialized asset

Novellus

concept 1 dielectric

Seller/s price (used

equipment)

$690,000

MV = VVS ×D

--

1.47

--

Accounting group

Quantity (Q)

Date in

Original Purchase Cost

Department

Valuation procedures:

Applied valuation procedure

Reasoning of valuation

approach selection

Producer

Model

Value Source (VS)

Value of the value source

(VVS)

Calculation formula:

Price index to valuation

date35,I

Delivery and Installation

Index (D)

Estimated cost new (CRN)\*,

USD:

CORLP calculation:

Normal life (NL), years

Remaining life (RL), years

Calculation formula:

CORLP\*, USD

Adjustment for functional

obsolescence:

CORLD\*, USD

Adjustment for economic

obsolescence:

MV, USD

\* Rounded

Machinery and equipment

1

Not in books

n/a

OPTICAL WAFER

PROCESSING

Cost approach

Specialized asset

Tystar

mini tytan 4600

Manufaturer’s Price

$380,000

СRN/COR = VVS × D

--

1.12

$423,800

Cost approach

Specialized asset

Agilent

81635A

Original Purchase Cost

$7,686

СRN/COR = VVS × I×D×Q

1.00

1.47

$45,200

--

--

10

4

10

10

COPLP  CRN   1 

--

--

--

--

$1,014,990





NL  RL 

NL





$423,800

0

$423,800

0

$423,800

$18,080

0

$18,080

0

$18,080

35

FM Global, http://www.fmglobal.com/

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Exhibit C

References Including Documents with Qualitative and

Quantitative Characteristics of the Property Appraised

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SELECTED INTANGIBLE AND TANGIBLE ASSETS VALUATION

Exhibit С – References

Documents36 used by the Valuer as defining qualitative and quantitative characteristics of the

property appraised are provided below.

#

1.1

1.2

1.3

1.4

Name

List of subject tangible and intangible assets

NeoPhotonics Russia project overview and business plan

Financial statements of NeoPhotonics Corporation

Overview of Technopolis Moscow site offering

Applicable standards are provided below.

 #

2.1

Name

Federal Law “Regulation of the Appraisal Activity in the Russian Federation” #135-FZ (amendments to

the law dated December 21, 2001; March 21 and November 14, 2002; January 10 and February 27,

2003; August 22, 2004; January 5 and July 27, 2006; February 5 and July 13, 2007, June 30, 2008)

The Federal Valuation Standards #1-#3 approved by the Russian Ministry for Economic Development

and Trade, Statements #256#254 respectively as of July 20, 2007

International Valuation Standards 2013 (IVS)

Decree of the Russian Ministry for Economic Development and Trade #303 “On confirmation of the

statute on procedures for expert examination of securities valuation report; on requirements and

procedures for selection of self-regulating organization of valuers, carrying out expert examination as of

September 29, 2006

Valuation Standards Code (VS 2010) of the Russian Society of Appraisers (RSA)

Russian accounting standards

International financial reporting standards

Business Valuation Standards of the American Society of Appraisers, June 1988

2.2

2.3

2.4

2.5

2.6

2.7

2.8

Bibliography is provided below.

#

3.1

3.2

3.3

3.4

3.5

3.6

3.7

3.8

Name

Roger J. Grabowski, “Equity Risk Premium: What is the Current Evidence?” 2005

Aswath Damodaran, Investment Valuation, 3rd edition. Alpina Business Book, 2006

James R. Hitchner, “Financial Valuation: Applications and Models”, John Wiley & Sons, 2003

Shannon P. Pratt, Robert F. Reilly and Robert P. Schweihs, “Valuing a Business: The Analysis and

Appraisal of Closely Held Companies”, 4th edition. McGraw-Hill, 2000

Shannon P. Pratt, Robert F. Reilly and Robert P. Schweihs, “Valuing Small Businesses and Professional

Practices”, 3rd edition. McGraw-Hill, 1998

American Society of Appraisers. Valuation of machinery and equipment, 2000

Infinera Corp. White papers of Photonic Integration Technology, 2011 and beyond

CISCO Visual Networking Index, 2014

Other sources of information are provided below.

 #

4.1

4.2

Name

The official exchange rates of foreign currencies against the Russian Ruble set by the Central Bank of

the Russian Federation on selected date www.cbr.ru

Statistic data, provided by Federal State Statistics Service of the Russian Federation: www.gks.ru

36

Documents provided by the Client. As agreed with the Client, copies of documents are provided in Exhibit F

and in electronic files on CD, that is an integral part of the Report

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Exhibit D

Information about the Client and the Valuer

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SELECTED INTANGIBLE AND TANGIBLE ASSETS VALUATION

Exhibit D1 – Information about the Client and the Valuer

Information about

the Client

Information about

the Valuer

Legal form and legal entity full name: NeoPhotonics Corporation

Location: 2911 Zanker Road, San Jose, CA 95134

Full name: Rumyantsev Alexander Yurievich

Membership in the Self-Regulated Organization (SRO) of Appraisers:

Member of self-regulated organization of valuers (Non-commercial

partnership Specialists and Valuers Community (SMAO) #0001 dated June

28, 2007, in the uniform state register of self-regulated organizations)

recorded in the registry of appraisers, registration #3559.

A copy of appraiser membership certificate is provided in Exhibit D4.

Professional education:

Plekhanov Russian Academy of Economics. Financial Valuation Certificate

PP # I №110453 dated July 30, 2010

Personal liability insurance data:

Policy of Valuer’s Liability Compulsory Insurance #433-068218/14, issued

by Ingosstrakh insurance company on September 15, 2014, effective from

September 25, 2014 till September 24, 2015

Work experience as an appraiser: since 2006

Valuer Location: Moscow, Russian Federation

Legal Address and

Other Pertinent

Information about

Valuation Company

employing the

Valuer

Limited liability company American Appraisal

Location: 1st Khvostov per., 11A Moscow 119180 Russian Federation

INN 9909014021

KPP 773851001

Main State Registration Number 5077746451085

OGRN date of issue: April 2, 2007

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Exhibit D2 – Certificate of Appraiser

I certify that, to the best of my knowledge and belief:

The statements of fact contained in this Report are true and correct.

The reported analyses, opinions, and conclusions are limited only by the reported assumptions

and limiting conditions, and represents the impartial and unbiased professional analyses,

opinions, and conclusions of LLC “American Appraisal”.

LLC “American Appraisal”, and I personally have no present or prospective interest in or bias

with respect to the property that is the subject of this Report and have no personal interest or

bias with respect to the parties involved.

The engagement of LLC “American Appraisal”, and myself personally in this assignment and

compensation for LLC “American Appraisal”, are not contingent on the development or reporting

of a predetermined value or direction in value that favors the cause of the client, the amount of

the value opinion, the attainment of a stipulated result, or the occurrence of a subsequent event

directly related to the intended use of this appraisal.

The analyses, opinions, and conclusions were developed, and this Report has been prepared,

in conformity with the International Valuation Standards (IVS) and Russian Federal Valuation

Standards #1-#3.

Members of my appraisal staff have made an inspection of the real and personal property that is

the subject of this Report.

In addition to those signing this Report the following people provided significant assistance

including investigation and research, as well as Report preparation – Alexander Lopatnikov,

Sergey Tsurinov, and Alexei Ovsiannikov.

Valuer

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

Alexander Rumyantsev

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SELECTED INTANGIBLE AND TANGIBLE ASSETS VALUATION

Exhibit D3 – Project Team

List of specialists participating in the project with their qualifications is provided below.

Specialist

Alexander

Lopatnikov

Participation

Selected intangible

assets valuation

TABLE 16. PROJECT TEAM

 Qualification

 Plekhanov Russian Academy of Economics. Valuation.

 Certificate of professional development # 164-7C, 2007.

London Business School Advanced Corporate Finance.

Executive Programme.

Plekhanov Russian Academy of Economics. Financial Valuation

Certificate PP # 409169.

The D. V. Efremov Scientific Research Institute of Electro Physical

Apparatus, Saint Petersburg. Post-graduate studies.

Moscow Engineering Physics Institute. Theoretical and Experimental

Physics.

Sergey

Tsurinov

Selected tangible

assets valuation

Leningrad Shipbuilding Institute. Qualification: ship constructor

Inter-industry Institute of Professional Development and

Management and Specialists Retraining.

Plekhanov Russian Academy of Economics.

Program "Valuation Activity".

Valuation Certificate of professional development # 175-7C, 2007.

Inter-industry Institute of Professional Development and

Management and Specialists Retraining.

Plekhanov Russian Academy of Economics. Professional valuation

and expert review of property and ownership rights. Business

enterprise (business) valuation. Business Enterprise (Business)

Valuation Certificate of professional development PP# 411100.

Courses in accounting

Leningrad State University, Automation Design Faculty,

Qualification: Software Engineer

Alexei

Ovsiannikov

Selected tangible

assets valuation

Plekhanov Russian Academy of Economics. Valuation. Certificate of

professional development # 165-7C, 2007.

Plekhanov Russian Academy of Economics. Financial Valuation

Certificate PP # 409170.

Moscow State Aviation Institute, Department of Business and

Management.

Moscow State University, Department of Economics.

B.A. Economics.

Moscow State University, Accounting Training Center:

International accounting training courses (GAAP).

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SELECTED INTANGIBLE AND TANGIBLE ASSETS VALUATION

Exhibit D4 – Appraiser Membership Details

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SELECTED INTANGIBLE AND TANGIBLE ASSETS VALUATION

Exhibit E

Assumptions and Limiting Conditions

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SELECTED INTANGIBLE AND TANGIBLE ASSETS VALUATION

Exhibit E – Assumptions and Limiting Conditions

This valuation consulting service was performed with the following general assumptions and

limiting conditions:

1.

To the best of our knowledge, all data, including historical financial data if any, relied upon

in reaching opinions and conclusions or set forth in this Report are true and accurate.

Although gathered from reliable sources, no guarantee is made nor liability assumed for

the truth or accuracy of any data, opinions, or estimates furnished by others that have

been used in this analysis.

No responsibility is assumed for matters legal in nature. No investigation has been made

of the title to or any liabilities against the property appraised. We have assumed that the

owner’s claim is valid, the property rights are good and marketable, and there are no

encumbrances that cannot be cleared through normal processes, unless otherwise stated

in the Report.

The value or values presented in this Report are based upon the premises outlined herein.

The date of value to which the conclusions and opinions expressed apply is set forth in

the Report. The value opinion herein rendered is based on the status of the economy and

on the purchasing power of the currency stated in the Report as of the date of value.

This Report has been made only for the use or uses stated, and it is neither intended nor

valid for any other use.

Possession of this Report or any copy thereof does not carry with it the right of publication.

No portion of this Report (especially any conclusion, the identity of any individuals signing

or associated with this Report or the firms with which they are connected, or any reference

to the professional associations or organizations with which they are affiliated or the

designations awarded by those organizations) shall be disseminated to third parties

through prospectus, advertising, public relations, news, or any other means of

communication without the written consent and approval of LLC “American Appraisal”.

Areas, dimensions, and descriptions of property, if any, used in this analysis have not

been verified, unless stated to the contrary in the Report. Any areas, dimensions, and

descriptions of property included in the Report are provided for identification purposes

only and should not be used in a conveyance or other legal document without proper

verification by an attorney.

Plans and maps, if any, presented in the Report are intended only as aids in visualizing

the property and its environment. Although the material was prepared using the best

available data, it should not be considered as a survey or scaled for size.

8.

Unless stated to the contrary in the Report, no environmental impact study has been

ordered or made. Full compliance with all applicable federal, state, and local

environmental regulations and laws is assumed unless otherwise stated, defined, and

considered in the Report. We have also assumed responsible ownership and that all

required licenses, consents, or other legislative or administrative authority from any local,

state, or national government or private entity organization either have been or can be

obtained or renewed for any use that is relevant to this analysis

The value estimate contained within the Report specifically excludes the impact of

substances such as asbestos, urea-formaldehyde foam insulation, other chemicals, toxic

wastes, or other potentially hazardous materials or of structural damage or environmental

contamination resulting from earthquakes or other causes, unless stated to the contrary

in the Report. It is recommended that the reader of the Report consult

a qualified structural engineer and/or industrial hygienist for the evaluation of possible

structural/environmental defects, the existence of which could have a material impact on

value.

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9.

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SELECTED INTANGIBLE AND TANGIBLE ASSETS VALUATION

Exhibit E – Assumptions and Limiting Conditions

10.

No soil analysis or geological studies were ordered or made in conjunction with the Report,

nor were any water, oil, gas, or other subsurface mineral and use rights or conditions

investigated, unless stated to the contrary in the Report.

It is assumed that all applicable zoning and use regulations and restrictions have been

complied with unless nonconformity has been stated, defined, and considered in the

Report. Further, it is assumed that the utilization of the land and improvements is within

the boundaries of the property described and that no encroachment or trespass exists

unless noted in the Report.

If we have made a physical inspection of the property, the inspection was made by

individuals generally familiar with real estate and building construction. However, we do

not opine on, nor are we responsible for, the structural integrity of the property including

its conformity to specific governmental code requirements, such as fire, building and

safety, earthquake, and occupancy, or any physical defects that were not readily apparent

to the appraisers during their inspection.

11.

12.

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