

November 10, 2014

**BUY**

## Cummins India

**Target Price (INR) 957**
**Uptrend in valuations to sustain on strong earnings**

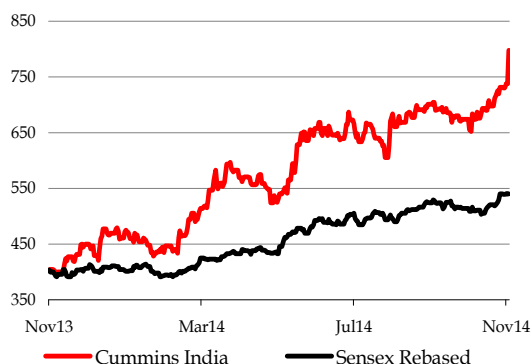
### Company Update ↑

**Last Price (INR) 798.2**

|                      |               |
|----------------------|---------------|
| Bloomberg code       | KKC IN        |
| Reuters code         | CUMM.BO       |
| Avg. Vol. (3m)       | 251,486       |
| Avg. Val.(3m)(INRmn) | 173           |
| 52-wk H/L (INR)      | 849 / 392     |
| Sensex               | 27,869        |
| MCAP (INRbn/USDbn)   | 221.26 / 3.59 |

| Shareholding (%) | 06/14 | 09/14 |
|------------------|-------|-------|
| Promoters        | 51.0  | 51.0  |
| MFs, Fls, Banks  | 21.6  | 21.9  |
| FII              | 12.8  | 12.5  |
| Public           | 9.3   | 9.2   |
| Others           | 5.3   | 5.5   |

### Stock Chart (Relative to Sensex)



| Stock Perfm. (%) | 1m   | 3m   | 1yr  |
|------------------|------|------|------|
| Absolute         | 21.9 | 16.7 | 97.9 |
| Rel. to Sensex   | 17.0 | 8.1  | 64.5 |

| Financials (INRmn) | 03/14  | 03/15f | 03/16f |
|--------------------|--------|--------|--------|
| Sales              | 38,991 | 42,685 | 49,172 |
| YoY (%)            | -14    | 9      | 15     |
| EBITDA (%)         | 15.9   | 15.1   | 16.0   |
| A.PAT              | 6,000  | 7,171  | 7,874  |
| Sh o/s (diluted)   | 277    | 277    | 277    |
| A.EPS (INR)        | 21.6   | 25.9   | 28.4   |
| YoY (%)            | -15    | 20     | 10     |
| D/E (x)            | -0.2   | -0.1   | -0.1   |
| P/E (x)            | 36.9   | 30.9   | 28.1   |
| EV/E (x)           | 35.0   | 33.8   | 28.0   |
| RoCE (%)           | 24     | 27     | 26     |
| RoE (%)            | 24     | 27     | 27     |

| Quarterly Trends | 12/13  | 03/14 | 06/14  | 09/14  |
|------------------|--------|-------|--------|--------|
| Sales (INRmn)    | 10,006 | 9,560 | 10,327 | 11,171 |
| PAT (INRmn)      | 1,472  | 1,418 | 2,120  | 2,024  |

KKC's strong revenue growth at 22% in Sep14 was driven by a spike in exports even as its domestic volumes continued to decline. Near term disruption in margins on implementation of CPCB-II norms was visible as gross and EBITDA margins declined q-o-q. Management has guided to margins remaining depressed in H2, before recovering in FY16. Adjusting for lower margins but higher export and other income growth, we increase FY15f EPS by 17%; FY16f-17f EPS is marginally increased. With short delivery cycles, KKC has potential for comparatively higher-than-forecast growth once capex cycle revives. We increase the target P/E to 30x upon across the board sector re-rating and in-line with its FY17f ROE. We roll-over our TP to Sep15 and raise it to 957 (from 687). Upgrade to BUY.

### Exports drive growth in Q2, domestic sales trend up in nominal terms

KKC's 22% revenue growth was driven by a rise in exports by 60% y-o-y and 24% q-o-q. Growth may have been driven by chunky one-time exports to China (25% of non-LHP exports). LHP exports run-rate was largely stable at INR1.2bn. Domestic revenue growth was flat y-o-y and power segment sales were up 8%; showing significant improvement over previous quarters' trend and aided by c20% pricing gains on CPCB-II norms implementation this quarter. The implied volume decline was in high single digits in the power segment. Compensating for some pre-buy in the previous quarter (c5%), the domestic volume growth trend (c-10%) has not changed significantly since Q1.

### Margins may remain soft as cost pass-through is gradual

Gross/EBITDA margins have declined by 186-bps/162-bps q-o-q. The eventual hit to margins post CPCB-II has been higher than expected. Adjusting for the strong growth in high margin exports, the margins erosion is sharper. Margins may soften further as complete cost pass through is constrained by the weak demand and sequential fall in exports. Higher other income and lower taxes made up for lower operating margins in the quarter. Subsidiary Valvoline Cummins resumed dividend payouts, contributing INR270mn as final dividend. Tax rate at 16% in Q2 was lower than the full year guidance of 19%-20%.

### We raise FY15f by 17%, room for upsides in FY16f-17f margins

Apart from LHP, India may additionally emerge as the global sourcing hub for mid-range engines and which may continue to drive high exports growth. We turn more conservative on the margin expectations post the Q2 performance. Hence our FY16f-17f EPS is only marginally increased and leaving scope for further upsides as the pricing power returns in the coming quarters.

### Upgrade to Buy with Sep15 TP INR957; re-rating to continue

We raise our target P/E to 30x supported by similar FY17f ROE and a relatively strong pricing power. The uptrend in P/E may sustain on KKC's comparatively strong earnings this quarter and across the board re-rating. We roll-over our TP to Sep15 and raise it to INR957 (from INR687 earlier) and upgrade it to a Buy. Slow capex recovery and large improvement in coal availability are the key risk factors.

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## We raise our FY15f EPS by 17%, FY16f-17f EPS marginally changed

### Exhibit 1: Earnings revision summary (standalone)

| (INRmn)       | FY15f  |        |         | FY16f  |        |         | FY17f  |        |         |
|---------------|--------|--------|---------|--------|--------|---------|--------|--------|---------|
|               | Old    | New    | Var (%) | Old    | New    | Var (%) | Old    | New    | Var (%) |
| Revenue       | 41,000 | 42,685 | 4       | 48,805 | 49,172 | 1       | 60,548 | 60,427 | 0       |
| EBITDA        | 6,647  | 6,441  | -3      | 8,767  | 7,852  | -10     | 11,762 | 10,879 | -8      |
| PAT           | 6,113  | 7,171  | 17      | 7,615  | 7,874  | 3       | 9,709  | 9,807  | 1       |
| EPS (INR)     | 22.1   | 25.9   | 17      | 27.5   | 28.4   | 3       | 35.0   | 35.4   | 1       |
| EBITDA margin | 16.2   | 15.1   | -112bp  | 18.0   | 16.0   | -199bp  | 19.4   | 18.0   | -142bp  |

Source: Company, IL&FS Institutional Equities

### Exhibit 2: Revenue growth assumptions (%)

|                       | FY11      | FY12      | FY13      | FY14       | FY15f    | FY16f     | FY17f     |
|-----------------------|-----------|-----------|-----------|------------|----------|-----------|-----------|
| Power                 | 29        | -7        | 29        | -30        | 3        | 10        | 30        |
| Industrial            | 27        | 24        | -4        | 2          | -5       | 15        | 33        |
| Automotive            | -10       | 144       | -37       | -25        | 10       | 20        | 33        |
| Distribution          | 14        | 18        | 16        | -1         | 0        | 5         | 12        |
| <b>Total domestic</b> | <b>22</b> | <b>-1</b> | <b>13</b> | <b>-16</b> | <b>1</b> | <b>10</b> | <b>25</b> |
| Exports               | 117       | 12        | 7         | -7         | 30       | 25        | 20        |
| <b>Total revenue</b>  | <b>39</b> | <b>3</b>  | <b>11</b> | <b>-14</b> | <b>9</b> | <b>15</b> | <b>23</b> |

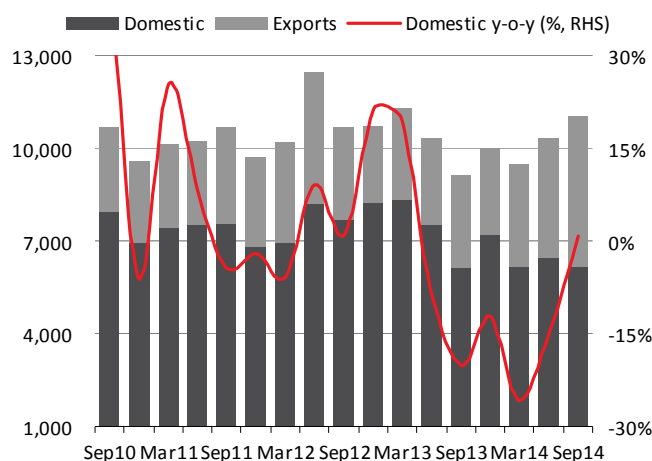
Source: Company, IL&FS Institutional Equities

### Exhibit 3: Quarterly trend in segment-wise revenue growth (%)

|                       | Dec12     | Mar13     | Jun13      | Sep13      | Dec13      | Mar14      | Jun14      | Sep14     |
|-----------------------|-----------|-----------|------------|------------|------------|------------|------------|-----------|
| Power                 | 50        | 26        | -26        | -36        | -20        | -38        | -11        | 8         |
| Industrial            | -6        | 13        | 30         | 8          | 1          | -22        | -27        | -4        |
| Automotive            | -5        | -5        | 0          | -44        | -36        | -19        | -35        | 60        |
| Distribution          | 15        | 19        | 7          | -7         | -3         | -8         | -9         | 0         |
| <b>Total domestic</b> | <b>21</b> | <b>19</b> | <b>-8</b>  | <b>-20</b> | <b>-12</b> | <b>-26</b> | <b>-15</b> | <b>1</b>  |
| Exports               | -15       | -9        | -34        | 0          | 12         | 11         | 42         | 60        |
| <b>Total revenue</b>  | <b>10</b> | <b>10</b> | <b>-17</b> | <b>-14</b> | <b>-7</b>  | <b>-15</b> | <b>0</b>   | <b>22</b> |

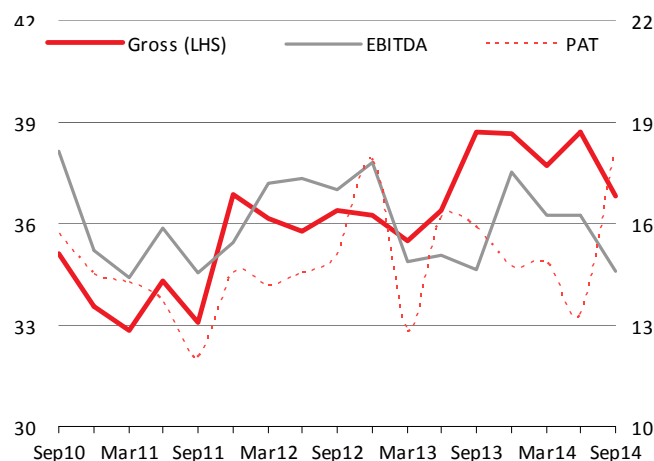
Source: Company, IL&FS Institutional Equities

### Exhibit 4: Revenue trend (INRmn)



Source: Company, IL&FS Institutional Equities

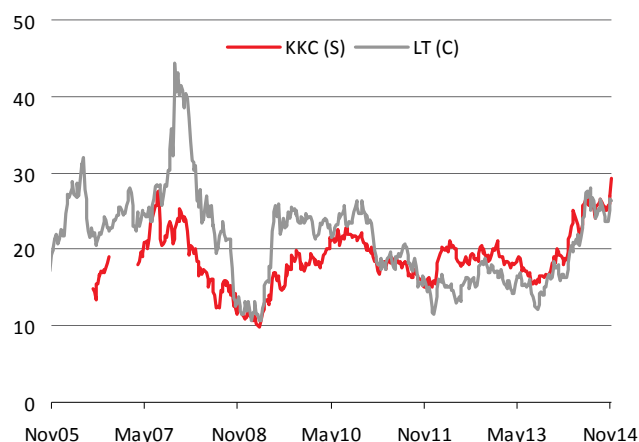
### Exhibit 5: Quarterly margin trend (%)



Source: Company, IL&FS Institutional Equities

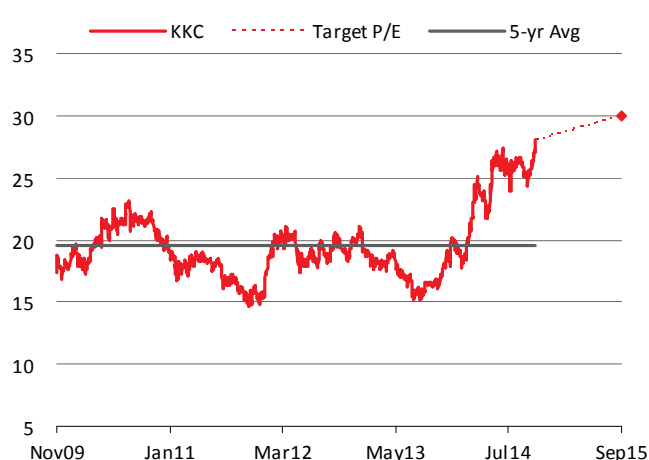
## Target P/E raised to 30x in-line with FY17f ROE

Exhibit 6: One-year forward P/E based on consensus (x)



Source: Company, IL&amp;FS Institutional Equities

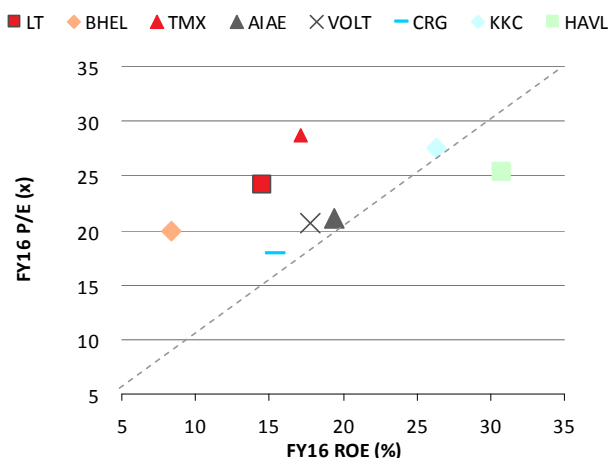
Exhibit 7: One-year forward P/E and target P/E (x)



Source: Company, IL&amp;FS Institutional Equities

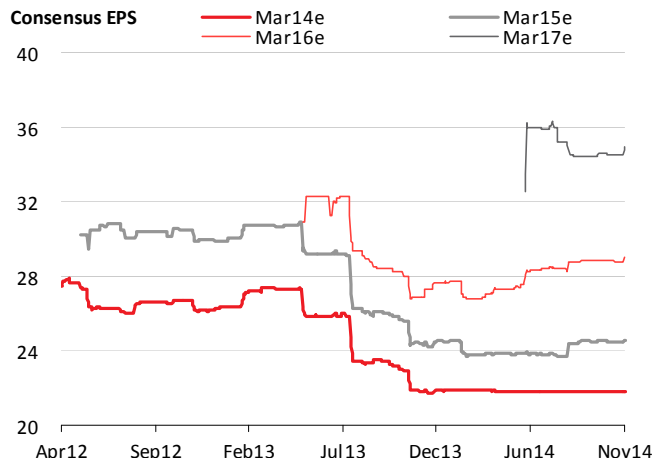
We raise our target P/E from 25x to 30x, bringing it in-line with KKC's FY17f ROE. Our earlier target P/E was benchmarked to LT's then one-year forward P/E of 25x. Subsequently, valuations across the board in the sector have increased. A further uptrend in KKC's P/E from the current levels may be supported by (i) reversal in margins as pricing power returns and market shares consolidate post CPCB-II, (ii) an early revival in KKC's revenue growth once the capex cycle revives, and (iii) tapering capex and rising FCF generation. New highs in margins may help sustain the P/E multiple at levels higher than the previous peak levels.

Exhibit 8: FY16f P/E (x) vs RoE (%)



Source: Bloomberg, IL&amp;FS Institutional Equities

Exhibit 9: Consensus EPS (INR)



Source: Company, IL&amp;FS Institutional Equities

## Key risk factors

- ▶ Slow capex recovery may impact demand pick-up.
- ▶ Higher coal/power availability and the rise of solar capacities may structurally impact genset demand.
- ▶ Weak demand may significantly delay a full pass-through of genset cost increases post CPCB-II.
- ▶ Sharp currency appreciation may adversely impact export margins.

## Exhibit 10: Result snapshot for the quarter

| (INRmn)                  | Mar13  | Dec13  | Mar14 | Jun14  | Sep14  | Y-o-y (%) | Q-o-q (%) |
|--------------------------|--------|--------|-------|--------|--------|-----------|-----------|
| Total operating income   | 11,280 | 10,006 | 9,560 | 10,327 | 11,171 | 17        | 8         |
| Total operating expenses | 9,604  | 8,255  | 8,007 | 8,653  | 9,541  | 19        | 10        |
| Inc/Dec in WIP           | -121   | -14    | -187  | -50    | -2     |           |           |
| RM Expenses              | 7,008  | 5,746  | 5,780 | 6,043  | 6,797  | 18        | 12        |
| Traded goods purchase    | 388    | 407    | 362   | 339    | 263    | -27       | -22       |
| Employee expenses        | 885    | 873    | 817   | 903    | 1,017  | 25        | 13        |
| Other expenses           | 1,443  | 1,243  | 1,235 | 1,417  | 1,467  | 19        | 4         |
| EBITDA                   | 1,676  | 1,751  | 1,553 | 1,674  | 1,630  | 5         | -3        |
| Other income             | 596    | 461    | 471   | 365    | 996    | 112       | 173       |
| Depreciation             | 124    | 133    | 146   | 186    | 204    | 40        | 10        |
| EBIT                     | 2,148  | 2,079  | 1,878 | 1,853  | 2,422  | 29        | 31        |
| Interest                 | 11     | 10     | 11    | 13     | 10     | -8        | -22       |
| Recurring PBT            | 2,137  | 2,069  | 1,867 | 1,841  | 2,412  | 29        | 31        |
| Net extra ordinary items | 491    | -      | -     | 826.30 | -      |           |           |
| PBT (reported)           | 2,627  | 2,069  | 1,867 | 2,667  | 2,412  | 29        | -10       |
| Tax                      | 742    | 597    | 450   | 547    | 388    | -14       | -29       |
| PAT (reported)           | 1,886  | 1,472  | 1,418 | 2,120  | 2,024  | 43        | -5        |
| Prior period items       | -      | -      | -     | -      | -      |           |           |
| Adj. Net Income          | 1,444  | 1,472  | 1,418 | 1,376  | 2,024  | 43        | 47        |
| Adj. EPS (INR)           | 5.2    | 5.3    | 5.1   | 5.0    | 7.3    | 43        | 47        |
| Ratios (%)               |        |        |       |        |        |           |           |
| EBITDA margin            | 14.9   | 17.5   | 16.2  | 16.2   | 14.6   |           |           |
| EBIT margin              | 19.0   | 20.8   | 19.6  | 17.9   | 21.7   |           |           |
| Effective Tax rate       | 28.2   | 28.8   | 24.1  | 20.5   | 16.1   |           |           |
| Net profit margin        | 12.8   | 14.7   | 14.8  | 13.3   | 18.1   |           |           |

Source: Company, IL&amp;FS Institutional Equities

## Financials and valuations (standalone)

### Income statement (INRmn)

| Fiscal year ending              | 03/14         | 03/15f        | 03/16f        | 03/17f        |
|---------------------------------|---------------|---------------|---------------|---------------|
| <b>Total operating income</b>   | <b>38,991</b> | <b>42,685</b> | <b>49,172</b> | <b>60,427</b> |
| <b>Total operating expenses</b> | <b>32,799</b> | <b>36,244</b> | <b>41,320</b> | <b>49,548</b> |
| <b>EBITDA</b>                   | <b>6,192</b>  | <b>6,441</b>  | <b>7,852</b>  | <b>10,879</b> |
| Other income                    | 2,553         | 3,374         | 3,376         | 3,461         |
| Depreciation                    | 528           | 807           | 1,084         | 1,384         |
| <b>EBIT</b>                     | <b>8,217</b>  | <b>9,009</b>  | <b>10,144</b> | <b>12,956</b> |
| Interest                        | 42            | 45            | 48            | 52            |
| Recurring PBT                   | 8,175         | 8,964         | 10,095        | 12,903        |
| Net extra ordinary items        | -             | -             | -             | -             |
| PBT (reported)                  | 8,175         | 8,964         | 10,095        | 12,903        |
| Total taxes                     | 2,175         | 1,793         | 2,221         | 3,097         |
| PAT (reported)                  | 6,000         | 7,171         | 7,874         | 9,807         |
| (+) Share in assoc. earnings    | -             | -             | -             | -             |
| Less: Minority interest         | -             | -             | -             | -             |
| Prior period items              | -             | -             | -             | -             |
| Net income (reported)           | 6,000         | 7,171         | 7,874         | 9,807         |
| <b>Adj. net income</b>          | <b>6,000</b>  | <b>7,171</b>  | <b>7,874</b>  | <b>9,807</b>  |
| Shares outstanding (mn)         | 277.2         | 277.2         | 277.2         | 277.2         |
| Adj. dil. shares (mn)           | 277.2         | 277.2         | 277.2         | 277.2         |
| <b>Adj. EPS (INR)</b>           | <b>21.6</b>   | <b>25.9</b>   | <b>28.4</b>   | <b>35.4</b>   |

### Growth ratios (%)

|                        |       |      |      |      |
|------------------------|-------|------|------|------|
| Total operating income | -13.5 | 9.5  | 15.2 | 22.9 |
| EBITDA                 | -17.9 | 4.0  | 21.9 | 38.5 |
| EBIT                   | -17.4 | 9.6  | 12.6 | 27.7 |
| Recurring PBT          | -17.4 | 9.6  | 12.6 | 27.8 |
| Adj. net income        | -14.6 | 19.5 | 9.8  | 24.5 |
| Adj. EPS               | -14.6 | 19.5 | 9.8  | 24.5 |

### Operating ratios (%)

|                    |      |      |      |      |
|--------------------|------|------|------|------|
| EBITDA margin      | 15.9 | 15.1 | 16.0 | 18.0 |
| EBIT margin        | 21.1 | 21.1 | 20.6 | 21.4 |
| Net profit margin  | 14.4 | 15.6 | 15.0 | 15.3 |
| Other income/PBT   | 31.2 | 37.6 | 33.4 | 26.8 |
| Effective Tax rate | 26.6 | 20.0 | 22.0 | 24.0 |

### Balance sheet (INRmn)

| Fiscal year ending        | 03/14         | 03/15f        | 03/16f        | 03/17f        |
|---------------------------|---------------|---------------|---------------|---------------|
| Equity capital            | 554           | 554           | 554           | 554           |
| Preference capital        | -             | -             | -             | -             |
| Reserves and surplus      | 25,097        | 27,113        | 30,477        | 34,485        |
| <b>Net worth</b>          | <b>25,652</b> | <b>27,668</b> | <b>31,032</b> | <b>35,039</b> |
| Minority interest         | -             | -             | -             | -             |
| Total debt                | -             | -             | -             | -             |
| Deferred tax liability    | 465           | 555           | 656           | 785           |
| <b>Total liabilities</b>  | <b>26,117</b> | <b>28,222</b> | <b>31,687</b> | <b>35,824</b> |
| Gross block               | 11,322        | 15,572        | 20,572        | 25,572        |
| less: Acc. depreciation   | 6,008         | 6,815         | 7,899         | 9,283         |
| Net block                 | 5,314         | 8,757         | 12,673        | 16,288        |
| CWIP                      | 4,835         | 6,085         | 6,085         | 3,085         |
| Goodwill                  | -             | -             | -             | -             |
| Investments               | 4,954         | 3,454         | 1,954         | 4,454         |
| Cash                      | 865           | 961           | 880           | 720           |
| Inventories               | 5,513         | 5,263         | 6,062         | 7,450         |
| Debtors                   | 7,820         | 7,977         | 8,515         | 9,933         |
| Loans and advances        | 8,426         | 8,209         | 8,781         | 9,958         |
| less: Current liabilities | 6,910         | 7,048         | 8,083         | 9,933         |
| less: Provisions          | 4,701         | 5,434         | 5,179         | 6,132         |
| Net working capital       | 11,014        | 9,927         | 10,976        | 11,997        |
| <b>Total assets</b>       | <b>26,117</b> | <b>28,222</b> | <b>31,687</b> | <b>35,824</b> |

### Cash flow statement (INRmn)

| Fiscal year ending               | 03/14         | 03/15f        | 03/16f        | 03/17f        |
|----------------------------------|---------------|---------------|---------------|---------------|
| Net profit                       | 6,000         | 7,171         | 7,874         | 9,807         |
| Depreciation                     | 528           | 807           | 1,084         | 1,384         |
| Deferred tax                     | 131           | 90            | 101           | 129           |
| Working capital changes          | -1,918        | 1,183         | -1,130        | -1,180        |
| Less: Other income               | 2,553         | 3,374         | 3,376         | 3,461         |
| <b>Cash flow from operations</b> | <b>2,188</b>  | <b>5,876</b>  | <b>4,554</b>  | <b>6,678</b>  |
| Capital expenditure              | -4,534        | -5,500        | -5,000        | -2,000        |
| Strategic investments            | -200          | -             | -             | -             |
| Marketable investments           | 1,522         | 1,500         | 1,500         | -2,500        |
| Change in other loans & adv.     | -             | -             | -             | -             |
| Goodwill paid                    | -             | -             | -             | -             |
| Other income                     | 2,553         | 3,374         | 3,376         | 3,461         |
| <b>Cash flow from investing</b>  | <b>-660</b>   | <b>-626</b>   | <b>-124</b>   | <b>-1,039</b> |
| Equity raised                    | -             | -             | -             | -             |
| Change in borrowings             | -             | -             | -             | -             |
| Dividends paid (incl. tax)       | -4,188        | -5,155        | -4,510        | -5,799        |
| Others                           | -22           | 0             | 0             | 0             |
| <b>Cash flow from financing</b>  | <b>-4,210</b> | <b>-5,155</b> | <b>-4,510</b> | <b>-5,799</b> |
| <b>Net change in cash</b>        | <b>-2,682</b> | <b>96</b>     | <b>-80</b>    | <b>-160</b>   |

### Key Ratios

| Fiscal year ending            | 03/14 | 03/15f | 03/16f | 03/17f |
|-------------------------------|-------|--------|--------|--------|
| <b>Valuation ratios (x)</b>   |       |        |        |        |
| P/E (on Adj. EPS)             | 36.9  | 30.9   | 28.1   | 22.6   |
| P/E (on basic, reported EPS)  | 36.9  | 30.9   | 28.1   | 22.6   |
| P/CEPS                        | 33.9  | 27.7   | 24.7   | 19.8   |
| P/BV                          | 8.6   | 8.0    | 7.1    | 6.3    |
| Dividend yield (%)            | 1.6   | 2.0    | 1.8    | 2.3    |
| Market cap. / Sales           | 5.7   | 5.2    | 4.5    | 3.7    |
| EV/Sales                      | 5.6   | 5.1    | 4.5    | 3.6    |
| EV/EBITDA                     | 35.0  | 33.8   | 28.0   | 20.0   |
| Net Cash / Market cap.        | 2.4   | 1.8    | 1.0    | 2.1    |
| <b>Per share ratios (INR)</b> |       |        |        |        |
| Adj. EPS                      | 21.6  | 25.9   | 28.4   | 35.4   |
| EPS (Basic, reported)         | 21.6  | 25.9   | 28.4   | 35.4   |
| Cash EPS                      | 23.5  | 28.8   | 32.3   | 40.4   |
| Book Value                    | 92.5  | 99.8   | 111.9  | 126.4  |
| Dividend per share            | 13.0  | 16.0   | 14.0   | 18.0   |
| Total assets / equity (x)     | 1.0   | 1.0    | 1.0    | 1.0    |
| <b>Return ratios (%)</b>      |       |        |        |        |
| ROCE                          | 24.0  | 26.5   | 26.4   | 29.2   |
| ROIC                          | 40.9  | 42.1   | 38.1   | 38.3   |
| ROE                           | 24.2  | 26.9   | 26.8   | 29.7   |
| ROA                           | 23.9  | 26.4   | 26.3   | 29.1   |
| OCF/Sales                     | 5.6   | 13.8   | 9.3    | 11.1   |
| FCF/Sales                     | -6.0  | 0.9    | -0.9   | 7.7    |
| <b>Turnover ratios (x)</b>    |       |        |        |        |
| Asset turnover (x)            | 1.5   | 1.6    | 1.6    | 1.8    |
| Gross asset turnover          | 3.4   | 2.7    | 2.4    | 2.4    |
| Inventory / Sales (days)      | 50.6  | 46.1   | 42.0   | 40.8   |
| Receivables (days)            | 76.6  | 67.5   | 61.2   | 55.7   |
| Payables (days)               | 110.1 | 95.5   | 90.6   | 89.2   |
| Working capital cycle (days)  | 86.0  | 81.7   | 70.7   | 64.5   |
| <b>Solvency ratios (x)</b>    |       |        |        |        |
| Gross debt to equity          | 0.0   | 0.0    | 0.0    | 0.0    |
| Net debt to equity            | -0.2  | -0.1   | -0.1   | -0.1   |
| Net debt to EBITDA            | -0.8  | -0.5   | -0.2   | -0.4   |
| Interest Coverage (on EBIT)   | 196.6 | 200.3  | 209.3  | 247.8  |

## Analyst Certification

The following analyst(s) is(are) primarily responsible for this report and, certifies(y) that the opinion(s) on the subject company(ies) and its security(ies) and any other views or forecasts expressed herein accurately reflect their personal view(s): Devang Patel

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The rating represents the expected change in the price of the stock over a horizon of 12 months.

|                            |                         |                           |                            |
|----------------------------|-------------------------|---------------------------|----------------------------|
| <b>Buy:</b> more than +15% | <b>Add:</b> +5% to +15% | <b>Reduce:</b> -5% to +5% | <b>Sell:</b> less than -5% |
|----------------------------|-------------------------|---------------------------|----------------------------|

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