



3R MATRIX

	+	=	-
Right Sector (RS)	✓	■	■
Right Quality (RQ)	✓	■	■
Right Valuation (RV)	✓	■	■
	+ Positive	= Neutral	- Negative

What has changed in 3R MATRIX

	Old		New
RS	■	↔	■
RQ	■	↔	■
RV	■	↔	■

ESG Disclosure Score

NEW

ESG RISK RATING

Updated Oct 08, 2021

13.12

Low Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

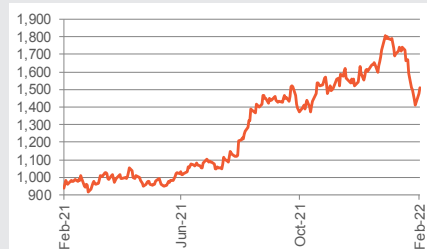
Company details

Market cap:	Rs. 146,330 cr
52-week high/low:	Rs. 1,837 / 915
NSE volume: (No of shares)	32.7 lakh
BSE code:	532755
NSE code:	TECHM
Free float: (No of shares)	62.3 cr

Shareholding (%)

Promoters	35.7
FII	36.2
DII	18.2
Others	9.9

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	(15.6)	1.1	24.4	60.1
Relative to Sensex	(15.0)	3.1	13.3	38.9

Sharekhan Research, Bloomberg

Tech Mahindra Ltd

Good Q3; picking right growth opportunities

IT & ITes	Sharekhan code: TECHM		
Reco/View: Buy	↔	CMP: Rs. 1,507	Price Target: Rs. 2,060 ↔
↑ Upgrade	↔ Maintain	↓ Downgrade	

Summary

- Q3FY22 revenue was broadly in-line, while margins lagged estimates; Q3 saw healthy deal intake, strong deal pipeline, net hiring, good client mining and robust growth in BPS business. CME division reported strong growth of 6.2% q-o-q.
- With healthy deal wins, strong hiring and broad-based demand, we expect strong revenue growth in enterprise vertical in the medium-term. TechM is well-placed to capture opportunities in the 5G space given a strong client base and investments in building capabilities.
- Strong revenue growth, lower sub-contractor expenses, higher offshoring, benefits from tier-II cities and price hikes would negate margin headwinds in FY2023. USD revenue/earnings would clock a CAGR of 12%/16%, respectively, over FY22-FY24E.
- We maintain a Buy on TechM with a PT of Rs. 2,060, given healthy deal wins, a strong deal pipeline, higher 5G contribution and scope for margin improvement.

Tech Mahindra (TechM) reported healthy revenue growth led by strong growth in communication, media & entertainment (CME) vertical, robust growth in the retail vertical and incremental revenue contribution from acquisitions. Reported US Dollar revenues grew by 4.1% q-o-q and 17.2% y-o-y to \$1,533.5 million, slightly exceeding our estimate by 0.8%. EBIT margin contracted by 36 bps q-o-q to 14.8%, below our estimate, owing to supply-side challenges, lower utilisation and higher sub-contractor expenses. Net new deal TCVs has been strong (~\$700 million) for last four consecutive quarters and stood healthy at \$704 million in Q3FY2022, broadly in-line with our expectations. With healthy deal wins, strong hiring, broad-based demand and higher 5G activity, we expect strong revenue growth momentum in FY2023E.

Key positives

- CME segment reported strong CC revenue growth of 6.9% q-o-q
- Net new deal TCVs stood healthy at \$704 million, up 55% y-o-y
- BPO business revenue grew strongly at 9.7%/35.3% q-o-q/y-o-y

Key negatives

- Share of sub-contractor costs in revenue increased to 16.4% from 15.3% in Q2FY22
- FCF declined 34% q-o-q, hence, FCF/net profit declined to 67% versus 104% in Q2

Revision in estimates – We tweaked our earnings estimates for FY22E/FY23E/FY24E factoring in Q3FY2022 results, broad-based demand and increasing 5G contributions.

Our Call

Valuation – Improving outlook: TechM is well-positioned to participate in the 5G opportunity across telecom service providers, ecosystem and enterprises given its sharp focus on digitisation, network integration with cloud and software architecture, investments in building capabilities along with people, partnerships and IP, besides a strong client base. The company's investments in building capabilities in enterprise segments through organic and inorganic routes would help it in gaining market share in BFSI, hi-tech, and healthcare verticals of the enterprise segment. At CMP, the stock is trading at a reasonable valuation of 21x/18x its FY2023E/FY2024E earnings estimates. We continue to prefer TechM, given improving execution, continued growth in the BPS business, strong pace of deal intake, scope for margin improvement and higher 5G activity among telecom players. We maintain a Buy rating on the stock with an unchanged price target (PT) of Rs. 2,060.

Key Risks

Any hostile development with respect to the current visa regime would affect employee expenses as lower proportion of local resources are deployed onsite. Further, a delay in pick-up of 5G-related spends would affect revenue estimates.

Valuation (Consolidated)

Particulars	Rs cr			
	FY21	FY22E	FY23E	FY24E
Revenue	37,855.1	44,412.4	51,057.2	57,713.8
OPM (%)	18.1	18.2	18.3	18.4
Adjusted PAT	4,478.8	5,492.3	6,429.5	7,379.9
% YoY growth	5.4	22.6	17.1	14.8
Adjusted EPS (Rs.)	51.2	62.7	73.4	84.2
P/E (x)	29.4	24.0	20.5	17.9
P/B (x)	5.3	4.8	4.4	4.0
EV/EBITDA (x)	19.6	16.3	13.8	11.8
RoNW (%)	19.0	21.2	22.7	23.7
RoCE (%)	20.5	23.7	25.4	26.8

Source: Company; Sharekhan estimates

Healthy revenue growth, but margin below estimate

TechM reported healthy CC revenue growth of 4.7% q-o-q, led by strong sequential 6.9% growth in communication, media & entertainment (CME) and incremental revenue contribution (~70 bps) from multiple small acquisitions. Reported US Dollar revenue grew by 4.1% q-o-q and 17.2% y-o-y to \$1,533.5 million, slightly exceeding our estimate by 0.8%. The BPS business reported strong revenue growth of 9.7% q-o-q. EBIT margin contracted by 36 bps q-o-q to 14.8%, below our estimate, owing to rising expenses to backfill higher attrition, lower utilization and rising sub-contractor expenses. Net profit came in at Rs. 1,368.5 crore (up 2.2% q-o-q) and was 4.8% below our estimate despite strong revenue growth, owing to lower-than expected other income (down 20.9% q-o-q). FCF declined by 34% q-o-q (and down 45% y-o-y) to \$123 million during the quarter, translating into an FCF to net profit conversion ratio of 67% versus 104% in Q2FY2022.

Key result highlights from earnings call

- ◆ **Healthy revenue growth:** TechM reported healthy revenue growth of 4.7% q-o-q and 17.5% y-o-y on CC basis in Q3FY2022. Organic growth remained at 4% on CC basis. Reported US Dollar revenue grew by 4.1% q-o-q and 17.2% y-o-y to \$1,533.5 million, slightly ahead of our expectations. The strong growth in CME segment (up 6.2% q-o-q) was primarily led by network services revenue. However, the growth in enterprise segment moderated to 2.7% q-o-q from 6.3% q-o-q in Q2FY2022, owing to weak seasonality in BFSI and hi-tech verticals. Within enterprise segment, retail, healthcare and manufacturing reported strong growth during the quarter. The BPS business segment reported strong revenue growth of 9.7% q-o-q and 35.3% y-o-y. Revenue from the top 5 and top 10 accounts grew strongly at 5.1% q-o-q and 4.3% q-o-q during the quarter.
- ◆ **Margins declined on q-o-q despite SG&A benefit:** EBIT margin declined 40 bps on q-o-q to 14.8%, owing to supply side challenges, salary hike, higher sub-contractor expenses (up 12% q-o-q) and lower utilisation (down 290 bps q-o-q). These margin headwinds during the quarter was partially offset by strong revenue growth, one-time SG&A benefits (~70-80 bps q-o-q) and operational efficiencies. Normalised SG&A is expected to remain slightly below 13% of total revenues in the coming quarters.
- ◆ **Investments to yield results going ahead:** The management indicated the company's investments in the areas of 5G, customer experience, data analytics, AI, IoT, and Cloud through organic or inorganic routes (multiple small acquisitions) over the past few quarters have started yielding results in terms of higher deal TCVs and strong revenue growth. The company's net new deal wins have been remained strong over the \$700 million during last four quarters, which is higher than its earlier quarterly deal win TCVs run-rate of \$400-500 million. The company's partner ecosystem is also getting stronger as it is creating new solutions by entering partnerships with both traditional players and new-age companies.
- ◆ **Growth outlook across segments remains intact:** Management remains confident of delivering of strong growth in both enterprise and CME segments. Organic growth of enterprise vertical moderated to 2% q-o-q in Q3FY2022, owing to weak seasonality in BFSI and Hi-tech verticals. However, the growth in healthcare and lifesciences, manufacturing and retail remained strong in enterprise segment during the quarter. The management stated that the growth in BFSI and hi-tech vertical would return in the coming quarters. With healthy deal wins, strong hiring and broad-based demand across verticals, we expect strong growth momentum in enterprise segment in FY2023. 5G activity is picking up among telecom companies, which would augur well for the company. Further, the company is in discussion with the customers for large engagements. Hence, we expect strong revenue growth in communication vertical for next 2-3 years.
- ◆ **Eyeing \$1-billion annual revenue run-rate in four verticals:** The management indicated that its four key verticals (BFSI, manufacturing, hi-tech and healthcare) in the enterprise space are on the path to cross the \$1 billion revenue run-rate given its strong digital competencies.
- ◆ **Increasing sub-contractor expenses:** The company's subcontractor expenses to total revenue increased to 16.4% from 15.3% in Q2FY2022, owing to restrictions on travel and higher demand for talents. The elevated rate of sub-contractor expenses is expected to continue in the near-term.
- ◆ **Sustainable margin performance to continue going ahead:** EBIT margin in Q3FY2022 declined 40 bps q-o-q despite a 70-80 bps q-o-q one-time benefit from SG&A and strong revenue growth. Management expects margins to remain stable in the near-term despite normalisation of SG&A expenses (SG&A cost to revenue likely to increase to around 13% in Q4 from 12.1% in Q3FY2022) and continued investments in sales and marketing practices in Q4FY2022. The increase in SG&A expenses to total revenue would be offset by strong revenue growth and increase in utilisation. The utilisation of the company is expected to stabilise 85-88% in coming quarters (84% in Q3FY2022). TechM plans to add more than 10,000 freshers in FY2023 to improve its pyramid structure. Margin levers including operating leverage, lower subcontractor expenses, delivery transformation, automation, higher offshoring, benefits from the tier-II cities and price increase are expected to negate the margin headwinds including higher discretionary

expenses, higher hiring and wage revisions in FY2023. We expect margins to remain stable with an upward bias over FY2022-24E.

- ◆ **Focus on modernizing the network and the underlying platforms in telecom segment:** The company remains positive on 5G opportunity given its continued investments in building capability over last 3-4 years. Over last 3-4 years, the company has been investing in the digital part of the network, people, software and IP to capture opportunities in 5G space. Hence, the company is not focusing much on network construction and deployment activity given commoditised nature of these businesses. Whereas, its strategy is to win more deals in the areas of system integration, design, automation, network integration with Cloud and software architecture, which would help in improving its margin profile. The company won mid-sized deals in the area of building predictive analytics on a 5G network during the quarter. The company's comprehensive 5G playbook is ready for (1) telecom service providers, (2) ecosystem and (3) enterprises. The company's investments in the ecosystem and on the network within the telecom service provider infrastructure and systems have started reaping good benefits to the company. The sense of urgency by enterprises in transforming the operating model would create opportunity for the company. The company is expected to remain at the forefront in participating in opportunities in 5G areas from the enterprise side, given its early investments.
- ◆ **BPS services:** The BPS business grew by 9.7% in US Dollar terms. The company's BPS business margin expanded 260 bps q-o-q to 20.8% in Q3FY2022 from 18.2% in Q2FY2022.
- ◆ **Healthy deal win momentum to continues, strong deal pipeline:** The company signed deals with a total TCVs of \$704 million versus \$750 million/\$456 million in Q2FY2022/Q3FY2021. Net new deal TCVs remained significantly higher for the last four consecutive quarters. Deal win TCVs declined by 3% q-o-q to \$478 million for the enterprise segment. Further, deal TCVs declined by 11% q-o-q to \$226 million for the CME segment. Management highlighted that the deal pipeline remained strong during Q3FY2022. The company's investments in capability building in the 5G space for telecom service providers, ecosystem and enterprises have been helping the company to reap benefits in terms of higher qualified deal pipeline in the 5G space.
- ◆ **Revenue grew across key regions:** The company's US business reported a strong revenue growth of 6.5% q-o-q (versus 8.9% q-o-q in Q2FY2022), while revenue from the Europe business accelerated to 2.7% q-o-q (versus 1.6% q-o-q in Q2FY2022). RoW business revenue growth moderated to 1.3% q-o-q.
- ◆ **DSO days increased:** DSO days increased by nine days to 101 days in Q3FY2022 from 92 days in Q2FY2022. DSO days increased on q-o-q as some collections from some large customers moved to January owing to holidays in the last week of December. With the improvement in collections, the DSO days will normalise in the coming quarters.
- ◆ **Weak cash generation:** TechM generated a quarterly FCF of \$123 million, down 34% q-o-q. FCF to PAT conversion ratio stood at 67% (versus 104% in Q2FY2022). Cash & cash equivalents declined to \$1,346 million in Q3FY2022 compared to \$1,626 million in Q2FY2022, owing to cash outflow towards acquisitions.
- ◆ **Strong net headcount additions:** Total headcount stood at 1,45,067 during Q3FY22, with net addition of 3,874 employees q-o-q, owing to headcount addition in IT services businesses. The BPO segment saw net headcount fall by 761 in Q3FY2022. The company's utilisation rate declined 84% from 86.9% in Q2FY2022. Attrition rate increased to 23.5% in Q3FY2022 versus 21.2% in Q2FY2022. The company hired 10,000 fresher during 9MFY2022. The management cited that fresher hiring would increase substantially in FY2023E given strong underlying demand environment and focus on pyramid improvement.
- ◆ **Spread-out the base for supply by entering into tier-II towns:** TechM has invested in nine tier-II cities of India to manage supply side issues. Further, the company expanded its presence in the near-shore locations and indicated that the strategy of widening presence in tier-II towns has worked out well. It hired ~8,000 employees in these tier-II towns over last couple of quarters. The average employee cost in these towns are 15% lower to the average employee expenses of remaining locations, while the dropout rate in these tier-II towns are lowered by 15%. Further, the availability of talents in niche areas such as Cloud, SAP HANA, etc in these tier-II towns would help the company to manage supply side issues efficiently. We believe that the expansion into tier-II towns would have positive impact in terms of availability of talents and cost going forward.
- ◆ **Acquisition spree to continue:** TechM's pace of small acquisitions is consistent with its historic trend and is focused to fill gaps in digital, domain and engineering capabilities or expansion into geographies or verticals. The company intends to return excess capital to the shareholders after investing in the right areas for the future.
- ◆ **Effective tax rate:** Management expects effective tax rate to be at 26-27% for FY2022, though the ETR was 26.7% in 9MFY2022.

Results (Consolidated)

Particulars	Q3FY22	Q3FY21	y-o-y (%)	Q2FY22	Rs cr
					q-o-q (%)
Revenue in USD (mn)	1,533.5	1,308.7	17.2	1,472.6	4.1
Revenue	11,450.8	9,647.1	18.7	10,881.3	5.2
Cost of Services	8,008.8	6,470.8	23.8	7,434.6	7.7
Gross profit	3,442.0	3,176.3	8.4	3,446.7	-0.1
SG&A	1,381.9	1,280.8	7.9	1,451.5	-4.8
EBITDA	2,060.0	1,895.4	8.7	1,995.2	3.2
Depreciation	362.1	358.4	1.0	343.0	5.6
EBIT	1,697.9	1,537.1	10.5	1,652.3	2.8
Other Income	223.1	220.9	1.0	282.1	-20.9
PBT	1,887.1	1,715.9	10.0	1,899.0	-0.6
Provision for taxes	508.2	426.3	19.2	557.2	-8.8
Reported net profit	1,368.5	1,309.8	4.5	1,338.8	2.2
EPS (Rs.)	15.5	14.9	4.0	15.1	2.1
Margin (%)			BPS		BPS
EBITDA	18.0	19.6	-166	18.3	-35
EBIT	14.8	15.9	-110	15.2	-36
NPM	12.0	13.6	-163	12.3	-35
Tax rate	26.9	24.8	209	29.3	-241

Source: Company; Sharekhan Research

Revenue mix: Geographies, industry verticals, and other operating metrics

Particulars	Revenue	Contribution	\$ Growth (%)	
	(\$ mn)	(%)	q-o-q	y-o-y
Revenue (\$ mn)	1,533	100	4.1	17.2
Geographic mix				
America	750	48.9	6.5	22.3
Europe	392	25.5	2.7	13.4
RoW	392	25.6	1.3	11.9
Industry verticals				
CME	627	40.9	6.2	18.0
Manufacturing	243	15.8	3.0	13.3
Technology	129	8.4	-2.3	17.0
BFSI	237	15.4	-1.4	13.4
Retail, transport and logistics	131	8.5	13.8	23.9
Others	167	10.9	5.0	20.9
Clients contribution				
Top 5	348	22.7	5.1	21.8
Top 10	482	31.4	4.3	20.3
Top 20	650	42.4	3.2	16.8
Revenue by services				
IT	1,337	87.3	3.2	14.8
BPO	194	12.7	9.7	35.3

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector outlook – Expect acceleration in technology spending going forward

Industry analysts such as Gartner estimate that IT services spending would grow by 7-9% over CY2021-CY2024E as compared to the average of 3.6% achieved in CY2010-CY2020. Forecasts indicate higher demand for cloud infrastructure services, potential increase in specialised software, potential investments in transformation projects by clients, and increased online adoption across verticals. Further, increasing need for rapid access to data and automation will enhance focus on network equipment and communications, speeding up 5G network deployments and adoption of 5G equipment.

■ Company outlook – Well-placed to capture 5G opportunity

TechM is well-placed to capture 5G-related spending from TSPs and OEMs, given its early investments in network capabilities through LCC, investments in IPs, platforms, and investments/partnerships (Intel, Rakuten, and AltioStar, among others) to develop an ecosystem. We remain positive on the company, considering strong demand in the telecom vertical, strategic focus on digital acquisitions, steady pace of deal intake and a continuous focus on diversifying the business. Improvement in execution led by efficient capital allocation is expected to augur well for the company.

■ Valuation – Improving execution

TechM is well-positioned to participate in the 5G opportunity across telecom service providers, ecosystem and enterprises given its sharp focus on digitisation, network integration with cloud and software architecture, investments in building capability along with people, partnerships and IP, and a strong client base. The company's investments in building capabilities in enterprise segments through organic and inorganic routes would help it in gaining market share in BFSI, hi-tech, and healthcare verticals of the enterprise segment. At CMP, the stock is trading at a reasonable valuation of 21x/18x its FY2023E/FY2024E earnings estimates. We continue to prefer TechM, given improving execution, continued growth in the BPS business, strong pace of deal intake, scope for margin improvement and higher 5G activity among telecom players. We maintain a Buy rating on the stock with an unchanged price target (PT) of Rs. 2,060.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBITDA (x)		P/BV (x)		RoE (%)	
				FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E
HCL Tech	1,133	271	3,07,350	22.6	19.9	15.0	13.2	4.9	4.6	21.4	23.0
Infosys	1,772	421	7,45,299	33.5	28.7	22.8	19.7	5.0	4.7	27.5	29.9
Tech M	1,507	97	1,46,330	24.0	20.5	16.3	13.8	4.8	4.4	21.2	22.7

Source: Company, Sharekhan estimates

About the company

Incorporated in 1986, TechM was formed with a joint venture between Mahindra & Mahindra and British Telecom Plc, under the name of Mahindra British Telecom. The company has been providing end-to-end services to telecom OEMs and service providers. Over the years, the company has acquired Comviva Technologies, LCC, and Hutchison Global Services to fill gaps in its service offerings in the telecom space. Notably, post the acquisition of Satyam, TechM entered the enterprise solutions space and became the fifth-largest Indian IT player. The company has now diversified its exposure to other verticals such as BFSI and manufacturing. TechM offers a bouquet of services including IT outsourcing services, consulting, next-generation solutions, application outsourcing, network services, infrastructure management services, integrated engineering solutions, business process outsourcing, platform solutions, and mobile value-added services.

Investment theme

TechM is one of the leading players in providing end-to-end services and solutions to telecom OEMs and major global service providers in the communication space (contributes more than 40% to its total revenue). Historically, this has helped the company whenever there is any uptick in technology spends, led by adoption of new technology. As the pace of spending from the roll-out of 5G network is likely to accelerate across the globe, TechM is well positioned to capitalise on the 5G opportunity across networks and IT services, given its investments in network capabilities, IPs, platforms, and partnerships. This has enabled the company to compete with large peers by striving for large deals in the enterprise segment.

Key Risks

- ◆ Any hostile development against the current visa regime would affect employee expenses as lower proportion of local resources are deployed onsite.
- ◆ Rupee appreciation or/and adverse cross-currency movements might affect earnings.
- ◆ Delay/loss of accounts in the enterprise segment.
- ◆ Delay in pick-up of 5G-related spends.

Additional Data

Key management personnel

Mr. Anand Mahindra	Chairman
CP Gurnani	Managing Director and Chief Executive Officer
Milind Kulkarni	Chief Financial Officer
Jagdish Mitra	Chief Strategy Officer and Head Of Growth
Manish Vyas	President, Communications, Media & Entertainment Business
Vivek Agarwal	President – BFSI, HLS and Corporate Development

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corp. of India	4.3
2	First State Investments ICVC	3.1
3	SBI Funds Management Pvt. Ltd.	2.8
4	BlackRock Inc	2.7
5	The Vanguard Group Inc.	2.3
6	ICICI Prudential Asset Management	1.9
7	Norges Bank	1.7
8	Government Pension Fund	1.5
9	FMR LLC	1.4
10	Schroders PLC	1.3

Source: Bloomberg

Sharekhan Limited, its analyst or dependant(s) of the analyst might be holding or having a position in the companies mentioned in the article.

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and deteriorating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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