



## 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 Jul 08, 2022

12.08

## Low Risk

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

Source: Morningstar

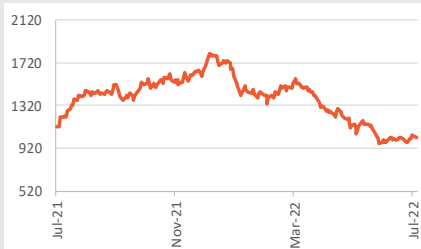
## Company details

Market cap:	Rs. 98,887 cr
52-week high/low:	Rs. 1,838 / 944
NSE volume: (No of shares)	31 lakh
BSE code:	532755
NSE code:	TECHM
Free float: (No of shares)	62.96 cr

## Shareholding (%)

Promoters	35.2
FII	30.4
DII	20.7
Others	13.6

## Price chart



## Price performance

(%)	1m	3m	6m	12m
Absolute	3.6	-20.3	-32.3	-9.2
Relative to Sensex	-2.1	-17.5	-28.6	-14.8

Sharekhan Research, Bloomberg

## Tech Mahindra Ltd

## Seasonally Soft quarter, reasonable valuation

IT &amp; ITes

Sharekhan code: TECHM

Reco/View: Buy



CMP: Rs. 1,017

Price Target: Rs. 1,220



Upgrade



Maintain



Downgrade

## Summary

- Tech Mahindra's (TechM) Q1FY2023 revenue was ahead of estimates, but EBIT margin lagged our estimates; Q1 saw strong deal intake, healthy deal pipeline, and good client mining. However, top accounts growth and cash generation remained weak.
- TechM is well poised to deliver strong revenue growth in the medium term, given strong deal wins, healthy deal pipeline, rising spending on 5G by telecom operators, and higher demand for cloud, connectivity, engineering, and XDS practices.
- Though wage revision is expected to weigh on Q2FY2023 margin, it would be offset by pricing leverage, recovery in the mobility business, and absence of large deal transition expenses. Management expects 100-150 bps q-o-q margin expansion in each quarter in FY2023.
- We maintain our Buy recommendation on TechM with a revised PT of Rs. 1,220, given robust deal wins, rising 5G spends, and reasonable valuation. The stock trades at 14x its FY2024E EPS.

Tech Mahindra (TechM) reported better-than-expected revenue growth performance, led by communication, media and entertainment (CME), manufacturing, technology, and retail verticals, while EBIT margin missed our estimates owing to supply-side pressure, large deal transition expenses, and higher SG&A expenses. The company reported sequential constant currency revenue growth of 3.5% and USD revenue growth of 1.5% to \$1,632.5 million, a tad ahead of our estimates. BPS business reported revenue growth of 2.1% q-o-q (5.1% on CC basis). EBIT margin contracted by 220 bps q-o-q to 11%, slightly below our estimates. Deal TCVs of \$802 million remained healthy in Q1, while LTM deal TCVs increased 19% y-o-y to \$3.3 billion, which provides strong growth visibility. We expect strong growth in both enterprise and CME segments in the medium term, given strong deal wins, higher spending on 5G by telecom operators, and accelerated spending on cloud, connectivity, engineering, and customer experience technologies. Though wage revision is expected to weigh on its EBIT margin in Q2FY2023, management indicated that margin headwinds would be offset by higher utilisation, pricing leverage, recovery in the mobility business, absence of large deal transition and visa expenses, and operational efficiencies.

## Key positives

- Net new deal TCVs on LTM basis grew by 19% y-o-y to \$3.3 billion in Q1
- Added six clients each sequentially in \$50 million+ and \$20 million+ revenue brackets
- Revenue in BPS business grew by 5.1% q-o-q on CC

## Key negatives

- Weak free cash flow (FCF) for the second consecutive quarter; FCF declined 58% y-o-y; hence, FCF/net profit ratio fell to 50% versus 56% in Q4FY2022
- Revenue from top-5/top-10/top-20 accounts declined by 5.8%/2.7%/1.8% on a q-o-q basis, respectively

## Management Commentary

- Management indicated that it does not see any impact in tech spending of its clients across industries amid adverse macro concerns, though it sees some slowdown in spending in selected clients.
- Management expects 100-150 bps sequential margin expansion in each quarter in the remainder of FY2023 and to achieve 14% EBIT margin by Q4FY2023.
- Strong growth in the CME segment would be driven by transformation activity within the telecom ecosystem, adoption of cloud, and network modernisation.
- The company will focus on integration of acquired entities in FY2023; less focus on acquisition spree.

**Revision in estimates** – We have slashed our earnings estimates for FY23E/FY24E/FY25E by around 7-9%, factoring in Q1FY23 results and anticipated slowdown in discretionary tech spends due to ongoing macro factors and potential recession in developed markets.

## Our Call

**Valuation – Strong outlook intact:** TechM's strong capabilities in 5G areas will help it to win more 5G deals across telecom ecosystems. However, the company's exposure towards discretionary spends in engineering, experience design services, and network modernisation would remain vulnerable during recessionary times. At the CMP, the stock is trading at a reasonable valuation of 17x/14x its FY2023E/FY2024E earnings estimates. We continue to prefer TechM, given improving 5G deals in the telecom space, continued growth in the BPS and XDS businesses, good deal wins, and scope for margin improvement. We maintain our Buy rating on the stock with a revised price target (PT) of Rs. 1,220.

## 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)

Rs cr

Particulars	FY22	FY23E	FY24E	FY25E
Revenue	44,646.0	52,859.4	57,917.2	64,180.6
OPM (%)	18.0	16.5	17.2	17.2
Adjusted PAT	5,566.1	5,398.9	6,295.7	7,068.2
% YoY growth	24.3	-3.0	16.6	12.3
Adjusted EPS (Rs.)	62.8	61.4	71.5	80.3
P/E (x)	16.2	16.6	14.2	12.7
P/B (x)	3.3	3.0	2.7	2.4
EV/EBITDA (x)	11.4	9.8	8.2	7.0
RoNW (%)	21.5	19.1	20.2	20.5
RoCE (%)	23.3	20.9	22.4	23.0

Source: Company; Sharekhan estimates

### In-line quarter in a soft seasonality; Weak cash generation

TechM reported better-than-expected CC revenue growth of 3.5% q-o-q, led by 3.9% q-o-q growth in CME and 3.2% q-o-q growth in the enterprise segment. Reported US Dollar revenue grew by 1.5% q-o-q and 18% y-o-y to \$1,632.5 million, a tad ahead of our estimates of \$1,626.3 million. BPS business reported revenue growth of 2.1% q-o-q (5.1% on CC basis). EBIT margin contracted by 220 bps q-o-q to 11%, slightly below our estimates, owing to 100-bps impact from higher retention, subcontractor and large deal transition-related expenses, 80 bps impact from soft seasonality in the mobility business, and 100 bps impact from SG&A normalisation, partially offset by better pricing (+50bps). Net profit came in at Rs. 1,131.6 crore (down 25% q-o-q) and was in-line with our estimates, owing to lower operating profitability, lower other income (down 62% q-o-q), and higher tax provision (22.8% versus 17.6% in Q4FY2022 because of absence of one-time reversal of tax benefit related to SEZ benefit). FCF declined by 35% q-o-q (and down 58% y-o-y) to \$72 million during the quarter, translating into an FCF to net profit conversion ratio of 50% versus 56% in Q4FY2022.

### Strong growth outlook in the medium term; Deal TCVs to remain strong

Management indicated that it does not see any impact in tech spending of its clients across industries amid adverse macro concerns. Management remains confident of delivering strong growth in both enterprise and CME segments in the medium term, given strong deal wins, strong spending on 5G by telecom operators, and higher spending in cloud, connectivity, engineering, and customer experience technologies. Deal TCVs of \$802 million remained healthy in Q1, while LTM deal TCVs increased 19% y-o-y to \$3.3 billion, which provides strong growth visibility. Further, management remains confident to report deal TCVs of \$700 million to \$1 billion in each quarter going ahead. We believe the company's strong capability in the XDS business will help it to win large deals. With healthy deal wins, strong hiring, and broad-based demand across verticals, we expect strong growth momentum in the enterprise segment in FY2023E. On the telecom front, the company continues to witness increasing spends around network modernisation, cloud, data, and customer experience. However, we believe growth momentum would moderate in FY2024, given anticipation of slowdown of tech spends owing to inflationary environment, macro headwinds, and potential recession in developed markets.

### Margins to expand sequentially in the remaining quarters of FY2023

Management cited that the company's operating profitability remained below its earlier expectations, which was primarily due to investments in building capabilities, expanding into tier-II cities, and establishing delivery centres. During Q1FY2023, EBIT margin declined 220 bps q-o-q to 11.0% (lowest in the past seven quarters) in Q1FY2023 owing to supply-side concerns, higher SG&A expenses, and weak seasonality. Management expects 100-150bps sequential margin expansion in each quarter of the remainder FY2023 and achieve 14% EBIT margin by Q4FY2023, aided by pricing leverage, higher utilisation, increased offshoring, and reduced subcontractor expenses. The impact of wage revision in Q2FY2023 is expected to be offset by higher utilisation, pricing leverage, recovery in the mobility business, absence of large deal transition and visa expenses, and operational efficiencies. We forecast the company is likely to report EBIT margin of 12.7% and 13.5% in FY2023E and FY2024E, respectively.

### Demand environment:

#### Key result highlights from earnings call

- ♦ **Decent revenue growth in a seasonally weak quarter:** The company reported CC revenue growth of 3.5% q-o-q, ahead of our estimates, led by 3.9% and 3.2% CC growth in CME and enterprise segments, respectively. In the enterprise segment, manufacturing, technology, retail, and HLS and others verticals grew by 5.7%, 6.4%, 6.8%, and 2% sequentially, respectively, in constant currency terms, while BFSI growth remained flat on a q-o-q basis. USD revenue grew sequentially by 1.5% q-o-q to \$1,632.5 million.
- ♦ **Demand outlook remains strong:** Management cited that demand is robust as it does not see any budget reductions from clients due to adverse macro environment, though it sees some slowdown in

spending in selected clients. Large deal momentum and order pipeline will progress as investments in cloud, connectivity, engineering, and customer experience will continue even if there is slowdown in the economy.

- ♦ **CME segment to continue growing strongly in FY2023:** The company remains positive on 5G opportunity, given its continued investments in building capability over the last 3-4 years. Over the last 3-4 years, the company has been investing in the digital part of the network, people, software, and IP to capture opportunities in the 5G space. The company's 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. Strong growth in the CME segment would be driven by (1) transformation activity within the telecom ecosystem because of digital transformation driven by 5G and readiness for 5G revenue growth by enterprises and (2) adoption of cloud, data on cloud or integrating data on cloud, etc., and (3) network modernisation. The company is expected to remain at the forefront in participating in opportunities in 5G areas from the enterprise side, given its early investments.
- ♦ **SGA expense and subcontracting costs:** Management cited that SGA increased by 16.6% sequentially to Rs. 17,116 million due to absence of one-time gain in the last quarter and rise in provision cost in the current quarter. Subcontracting costs remained at 16.3% of its revenue in Q1FY2023. Management expects there will be significant reduction in subcontracting costs in case of demand slowdown.
- ♦ **Strong deal pipeline, expect sustainable deal TCVs going ahead:** Deal pipeline remains strong for existing accounts and new accounts. The company focuses on higher deal conversions and targets deal TCVs of \$700 million to \$1 billion in every quarter. During Q1FY2023, the company won deal TCVs of \$802 million, which is in the similar range of deal TCVs in the last four quarters.
- ♦ **Focuses on organic growth and margin expansion:** The company has two internal focus areas – (1) organic growth, so it will focus on integrating the acquired entities (around 11 acquisitions in the last 15 months with a cash outlay of more than \$880 million) going ahead and (2) recovery in the profitability.
- ♦ **Focus on integration:** TechM has done around 11 acquisitions in the preceding five quarters, hence it expects lower M&A activities going forward. Regarding acquisition of Com Tech Co IT Ltd., TechM said it has wound down the customer operations unit in Belarus due to the war and shifted willing employees to other parts of Europe due to which it incurred one-time costs. However, revenue was not affected due to this change.
- ♦ **Headcount addition moderated; Attrition rate declined:** Total headcount stood at 1,58,035 during Q1FY2023, with net addition of 6,862 employees q-o-q, owing to headcount addition across IT services and BPO businesses. The BPO segment also saw net headcount addition of 4,077 in Q1FY2023. The company's utilisation rate remained stable sequentially at 83%. Attrition rate declined to 22.2% from 23.5% in Q4FY2022. Fresher hiring was low, given huge fresher hiring in the previous quarters.
- ♦ **Weak growth in top accounts:** Revenue from top-5, top-10, and top-20 accounts declined by 5.8% q-o-q, 2.7% q-o-q, and 1.8% q-o-q, respectively. Growth outside top accounts remained strong during the quarter.
- ♦ **Effective tax rate:** Management expects effective tax rate to be at 26-27% for FY2023, though ETR was 22.8% in Q1FY2023.
- ♦ **Weak cash generation continued for the second consecutive quarter:** TechM generated quarterly FCF of \$72 million, down 35% q-o-q. FCF to PAT conversion ratio stood at 50.2% (versus 56% in Q4FY2022). Management cited it will be able to achieve FCF to PAT % to the historical 90-110% by Q4FY2023. Cash and cash equivalents declined to \$1,114 million in Q1FY2023 compared to \$1,141 million in Q4FY2022.
- ♦ **DSO days increased:** DSO days increased by three days sequentially to 100 days in Q1FY2023.

## Results (Consolidated)

Particulars	Q1FY23	Q1FY22	Y-o-Y %	Q4FY22	Q-o-Q %
Revenue in USD (mn)	1,632.5	1,383.6	18.0	1,608.1	1.5
Revenue	12,707.9	10,197.6	24.6	12,116.3	4.9
Cost of Services	9,116.2	6,968.2	30.8	8,560.3	6.5
Gross profit	3,591.8	3,229.3	11.2	3,555.9	1.0
SG&A	1,711.6	1,353.0	26.5	1,467.6	16.6
EBITDA	1,880.1	1,876.4	0.2	2,088.4	-10.0
Depreciation	476.7	331.1	44.0	484.2	-1.6
EBIT	1,403.4	1,545.3	-9.2	1,604.1	-12.5
Other Income	122.1	287.3	-57.5	319.8	-61.8
PBT	1,485.2	1,794.5	-17.2	1,868.7	-20.5
Provision for taxes	338.0	428.6	-21.1	328.0	3.0
Reported net profit	1,131.6	1,353.2	-16.4	1,505.6	-24.8
EPS (Rs.)	12.8	15.3	-16.6	16.9	-24.6
Margin (%)			BPS		BPS
EBITDA	14.8	18.4	-361	17.2	-244
EBIT	11.0	15.2	-411	13.2	-220
NPM	8.9	13.3	-436	12.4	-352
Tax rate	22.8	23.9	-113	17.6	521

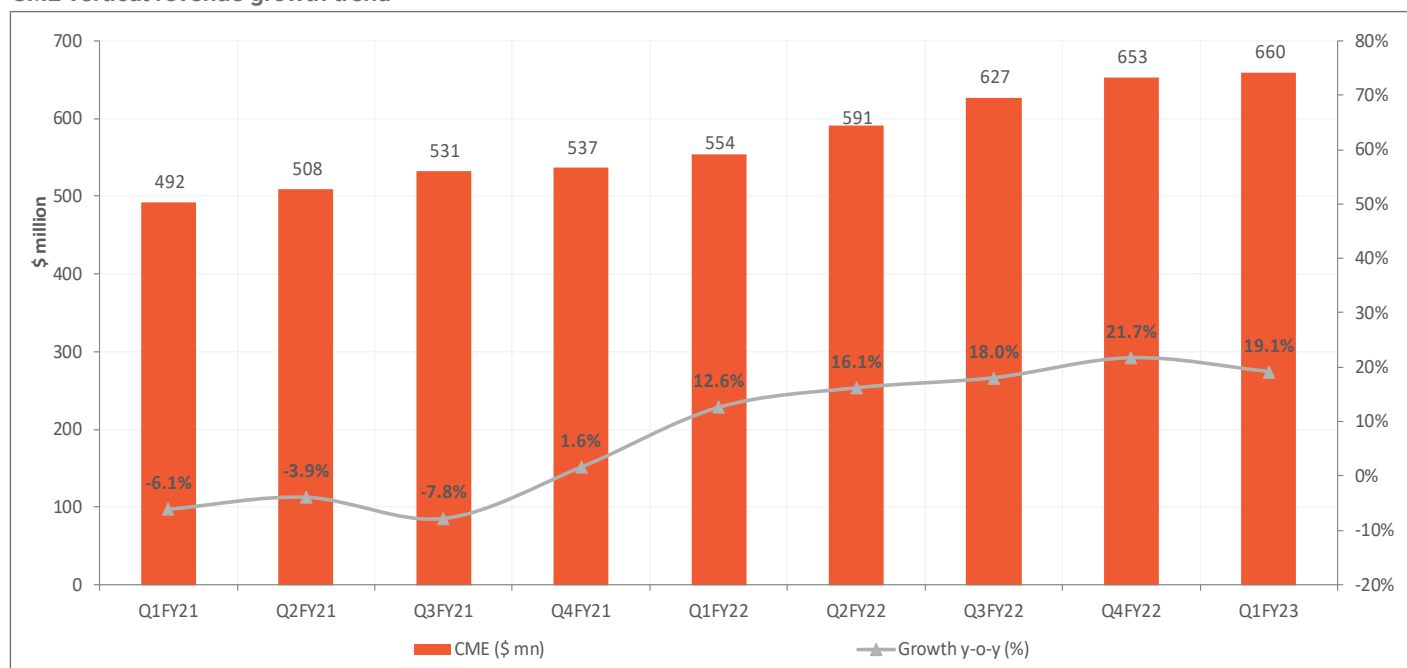
Source: Company; Sharekhan Research

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

Particulars	Revenue	Contribution	\$ Growth (%)	
Particulars	(\$ mn)	(%)	Q-o-Q %	Y-o-Y %
Revenue (\$ mn)	1,632	100	1.5	18.0
Geographic mix				
America	810	49.6	4.2	25.4
Europe	416	25.5	-1.9	10.8
RoW	397	24.3	-2.5	9.9
Industry verticals				
CME	660	40.4	1.0	19.1
Manufacturing	250	15.3	4.2	9.3
Technology	158	9.7	5.9	30.1
BFSI	273	16.7	-2.6	20.3
Retail, transport and logistics	129	7.9	5.5	21.4
Others	163	10.0	-0.5	11.2
Clients contribution				
Top 5	335	20.5	-5.8	9.2
Top 10	488	29.9	-2.7	13.8
Top 20	674	41.3	-1.8	12.7
Revenue by services				
IT	1,429	87.4	1.5	16.8
BPO	207	12.6	2.1	28.9

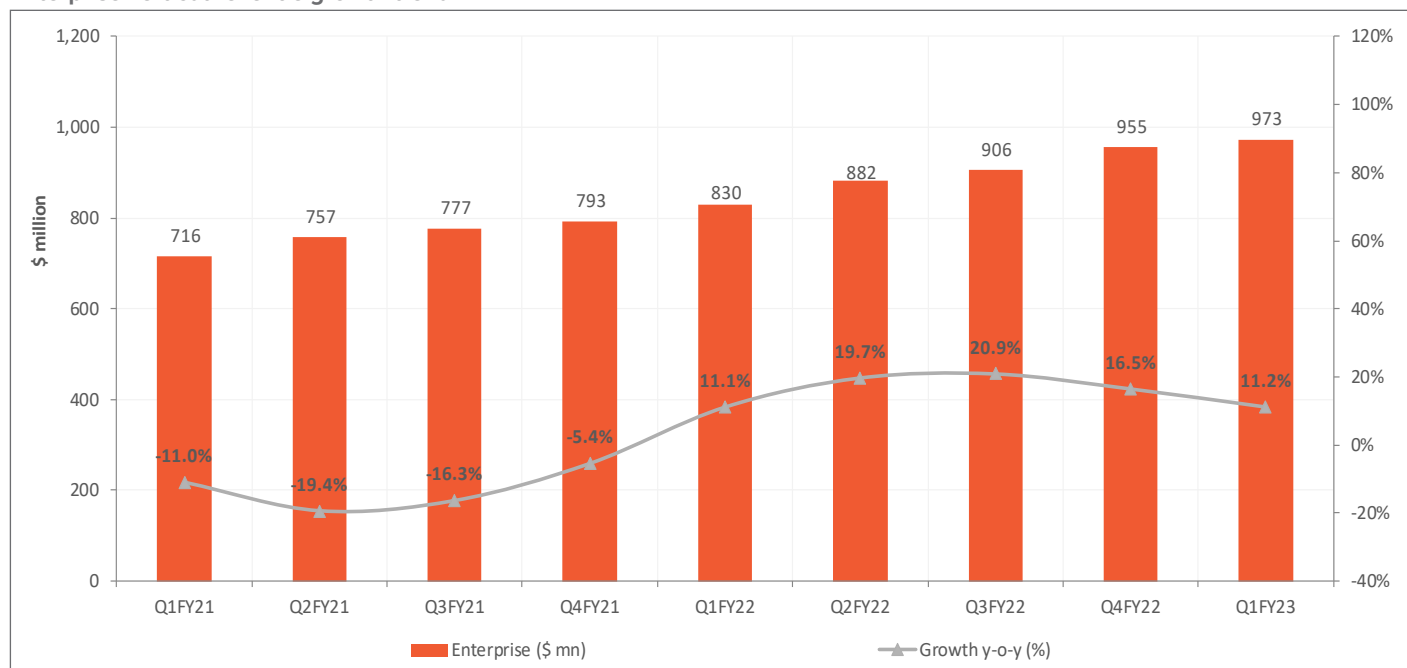
Source: Company; Sharekhan Research

### CME vertical revenue growth trend



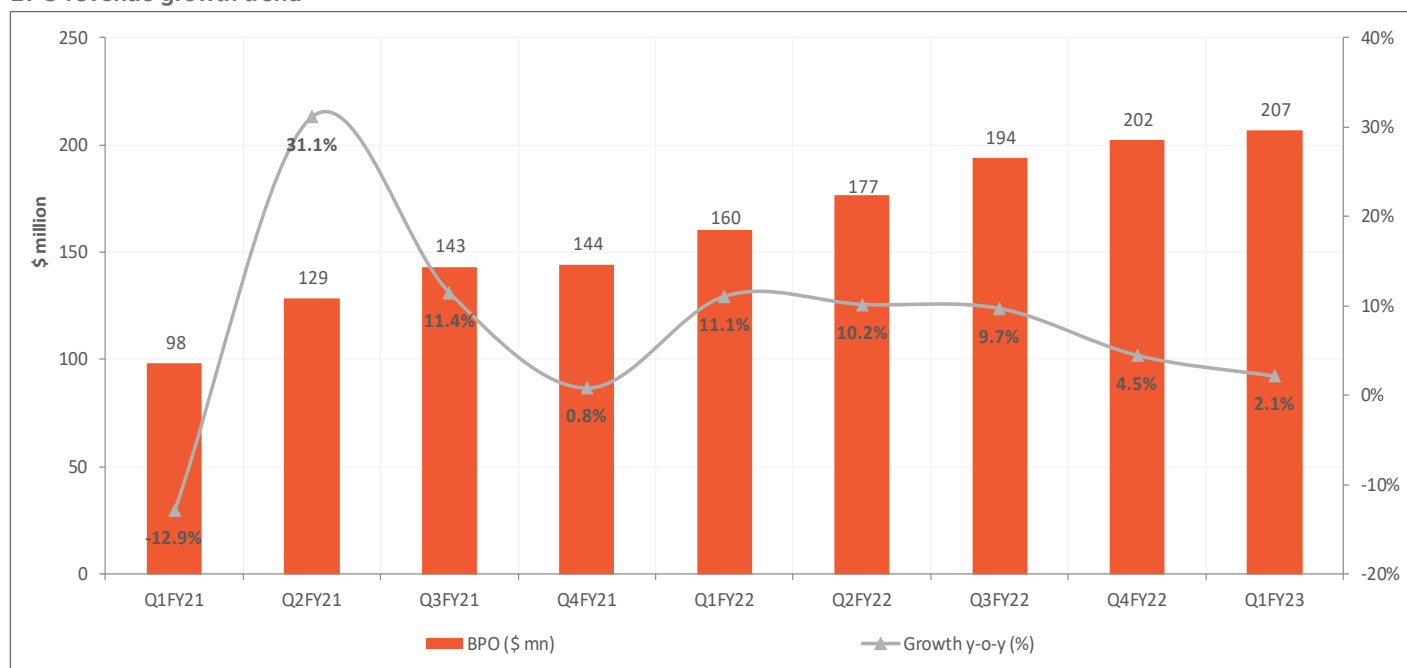
Source: Company; Sharekhan Research

### Enterprise vertical revenue growth trend



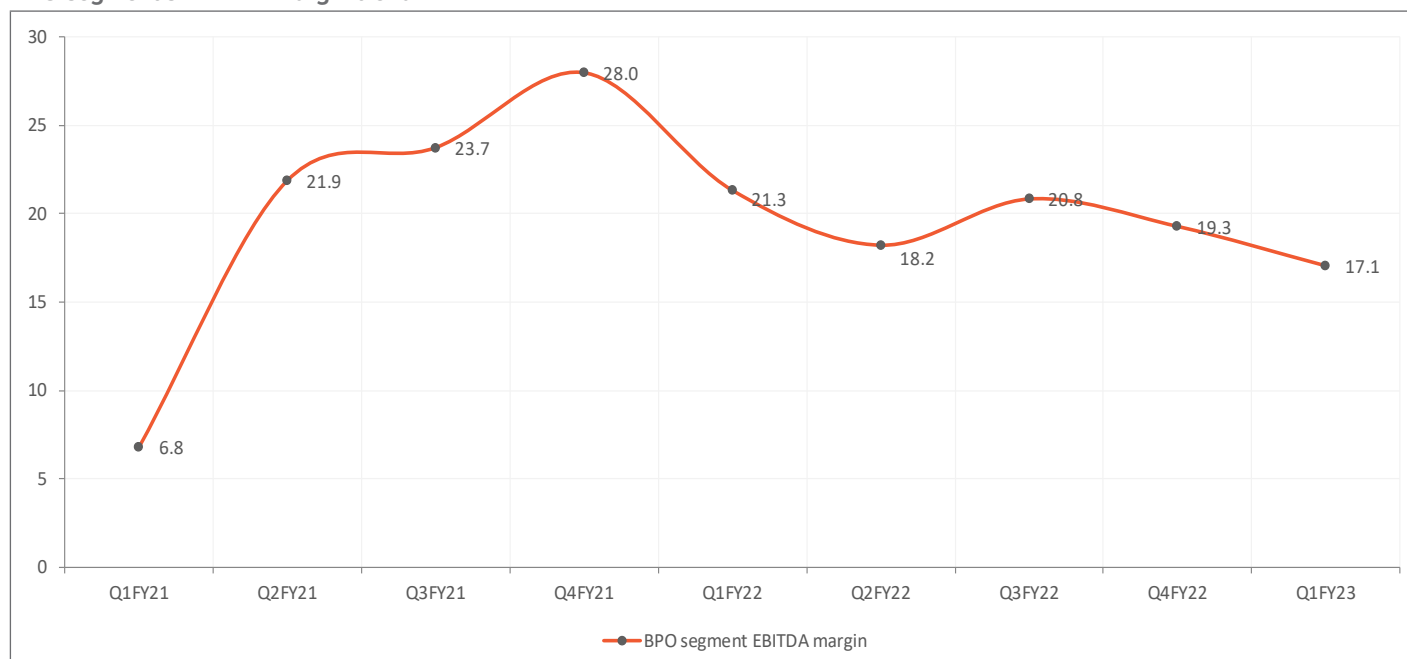
Source: Company; Sharekhan Research

### BPO revenue growth trend



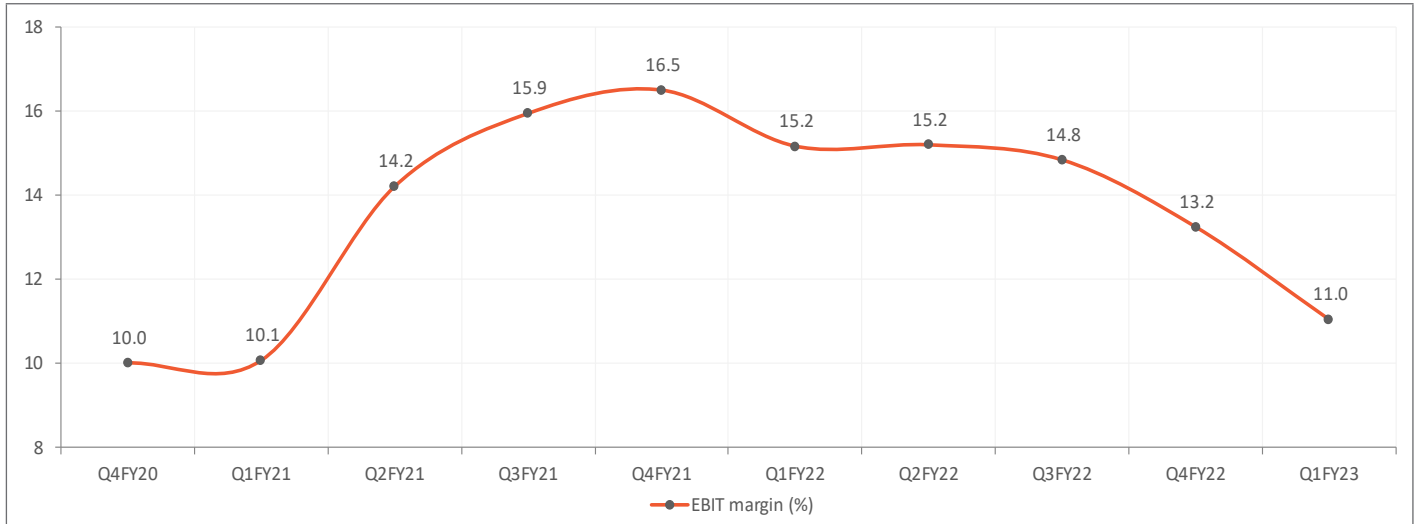
Source: Company; Sharekhan Research

### BPO segment's EBITDA margin trend



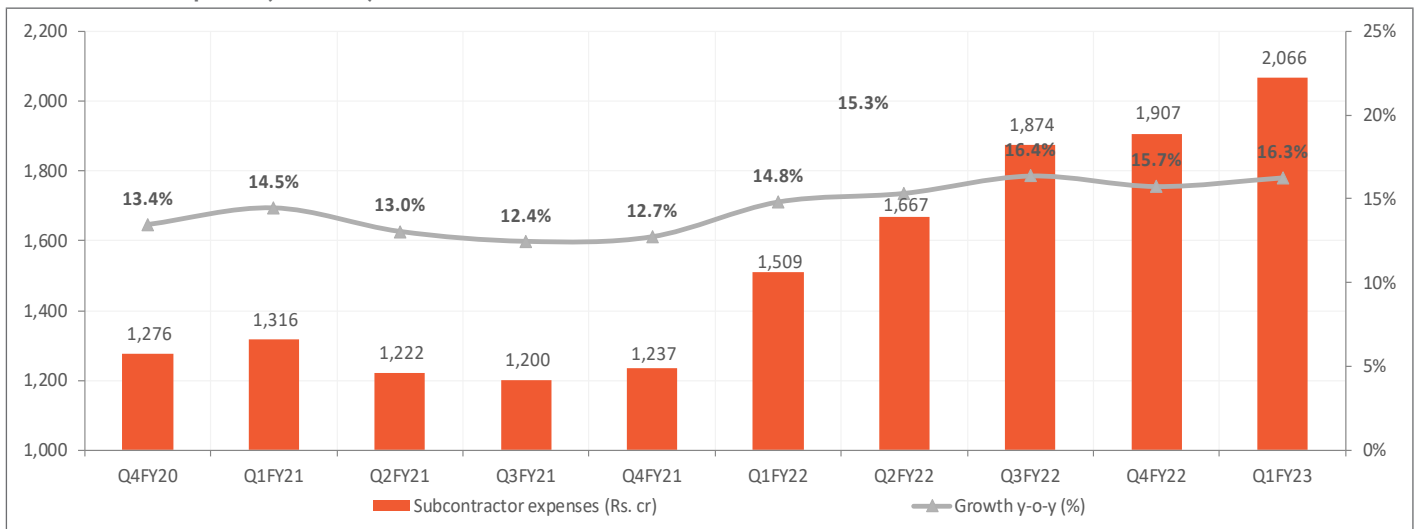
Source: Company; Sharekhan Research

### Tech M's EBIT margin trend



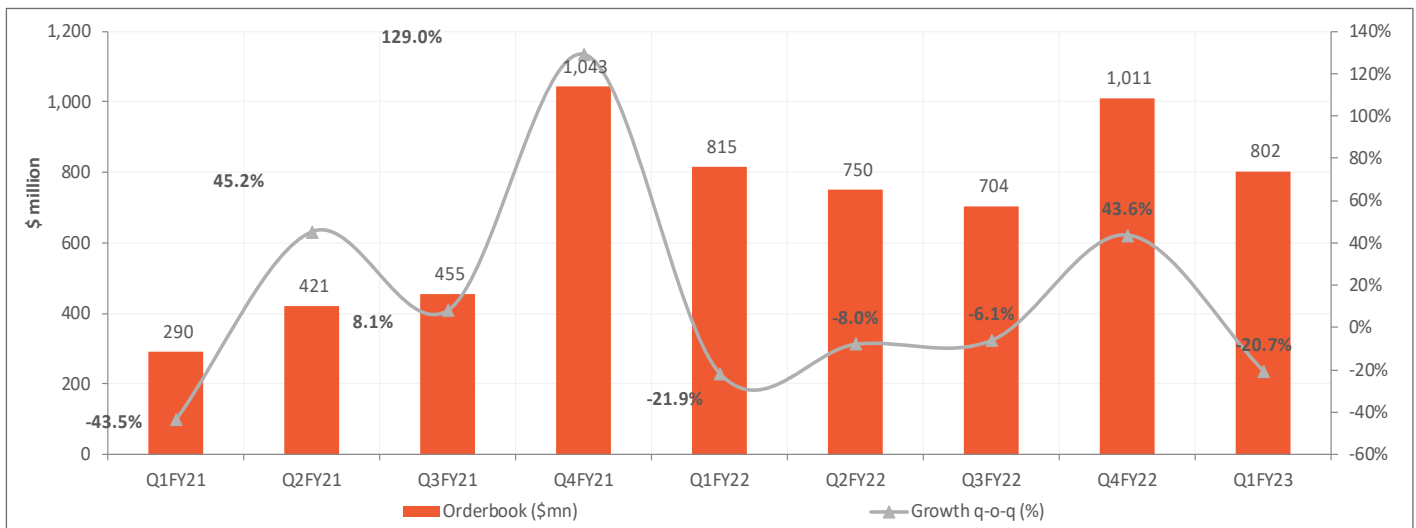
Source: Company; Sharekhan Research

### Subcontractor expense (Rs. crore) and as a % of revenues



Source: Company; Sharekhan Research

### New deal win TCV trend



Source: Company; Sharekhan Research

## Outlook and Valuation

### ■ Sector View – 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 – Strong outlook intact

TechM's strong capabilities in 5G areas will help it to win more 5G deals across telecom ecosystems. However, the company's exposure towards discretionary spends in engineering, experience design services, and network modernisation would remain vulnerable during recessionary times. At the CMP, the stock is trading at a reasonable valuation of 17x/14x its FY2023E/FY2024E earnings estimates. We continue to prefer TechM, given improving 5G deals in the telecom space, continued growth in the BPS and XDS businesses, good deal wins, and scope for margin improvement. We maintain our Buy rating on the stock with a revised PT of Rs. 1,220.

One-year forward P/E (x) band



Source: Company, Sharekhan Research



## About 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 original equipment manufacturers (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	4.31
2	First State Investments ICVC	3.07
3	SBI Funds Management Pvt. Ltd.	2.75
4	BlackRock Inc	2.68
5	The Vanguard Group Inc.	2.29
6	ICICI Prudential Asset Management	1.90
7	Norges Bank	1.74
8	Government Pension Fund	1.48
9	FMR LLC	1.35
10	Schroders PLC	1.30

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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