Dimensional Securities Pvt Ltd.

Date: 6th August, 2019
CMP: 260
Recommendation: BUY
Target: 323

ITC Ltd.

Initiating coverage

MARKET DATA	
NSE TICKER	ITC
Networth fy19 (Rs in Crs)	59,141
P/BV Ratio (FY19) (x)	5.4
EPS (FY19)(Rs.)	10.3
Market Price (Rs.)	260
P/E Ratio (FY19) (x)	25.2
52 Week High (Rs)	323
52 Week Low(Rs)	260
Market Capitalisation (rs. Cr)	318,862

AVERAGE MONTHLY VOLUME ('mn)	
BSE	0.47
NSE	11.6

SHARE HOLDING PATTERN	
Promoter	0.0
FII	16.7
DII	73.7
Public	9.6

RETURN (%)	3M	6M	12M
ITC	-14.8	-6.2	-13.2
Nifty	-6.2	0.8	-2.2

Ravindra Bhandari (Research Head)

ravindra@dimensional.in

+91-22-66545256

ITC is the monopoly business in cigarette in India contributing more than 85% of the legal cigarette consumption along with significantly high tax consumption on tobacco in the country. ITC has ventured into different businesses to diversify from the cigarette, however cigarette continue to contribute more than 45% and 85% of the overall revenue and EBIT of the company.

Cigarette remain key driver for valuation uplift

Cigarette remain addictive consumption and demographic distribution of India will remain important factor for increasing cigarette consumption in the country. As women participation is increasing, this will lead to further increase in volume.

- Legal cigarette despite contributing merely 10% in terms of volume of tobacco consumption in India is contributing more than 86% of the tax revenue. We believe government will take cognisance of such discrepancy and take initiative not to boost cigarette consumption but bringing some taxes on the other non-tax paying tobacco consumption. This will also bring in addition revenue to the government and provide better playing field for tax paying tobacco players.
- Number of cigarette consumption per capita in India is far lower compared to its immediate peers, this is due to differential tax treatment on other products. Also, the affordability is lower on high cost cigarette. Affordability is improving as the disposable income for the middle class is increasing.

Non Cigarette FMCG business has achieved sizeable scale

Other FMCG business of the company has achieved over Rs 12,500cr revenue in FY19. Among listed players, this is only lower to HUL ltd and far higher than other major peers like Dabur, Marico, Godrej. Since ITC focus has been on achieving scale ahead of profitability, we see subdued EBIT margin in other FMCG business. We expect EBIT margin to gradually improve as the company gets economies of scale with increasing revenue. Many of the brands in this segment are market leader and will help in driving margin higher for the company.

Hotel, Agri and Paper business will be slow mover in the entire business

Significant portion of Agri and paper business should be seen as support businesses to the cigarette due to large intersegment sales. Hotel and Paper segment is supported by limited supply in the industry. In hotels rooms addition in last few years has been slow, while paper producers are overleveraged and currently not expanding. ITC business outside FMCG will continue to grow, albeit slowly.

Valuation at historical low

We Value ITC on a SoTP method, with each segment valued as per its competitive intensity and ITC bargaining power in the segment. Cigarette being a monopoly is valued at 16x EV/EBIT, is significantly lower than last 5yr average. Other FMCG business is valued at EV/Sales as margin is currently on upmove and yet to stabilize.
ITC is trading at 25x of FY19 EPS, which is about 15% discount to historical 5yr average and yielding 3.6% FY21 FCF yield, which gives us valuation comfort for investing at current price.

Valuation & View

Given the above thesis, we are optimistic on ITC's prospects and accordingly recommend a BUY on the stock. We are valuing the company's share at Rs. 323 based on SoTP, representing a potential upside of 24% from the CMP of Rs. 260.

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Financial Snapshot:

Segment	Year	Metric	Value	Multiple	EV	% of Value
Cigarette	FY21	EV/EBIT	18,026	16	288,420	73%
Non Cigarette FMCG	FY21	EV/Sales	14,360	5	71,801	18%
Hotel	FY19	Assets Value	7,302	0.8	5,842	1%
Paper	FY21	EV/EBIT	1,163	6	6,978	2%
Agri	FY21	EV/EBIT	788	5	3,942	1%
Total					376,984	
Cash & Eq (FY19)					17,500	4%
Fair Value					394,483	
Target Price					323	

About Company

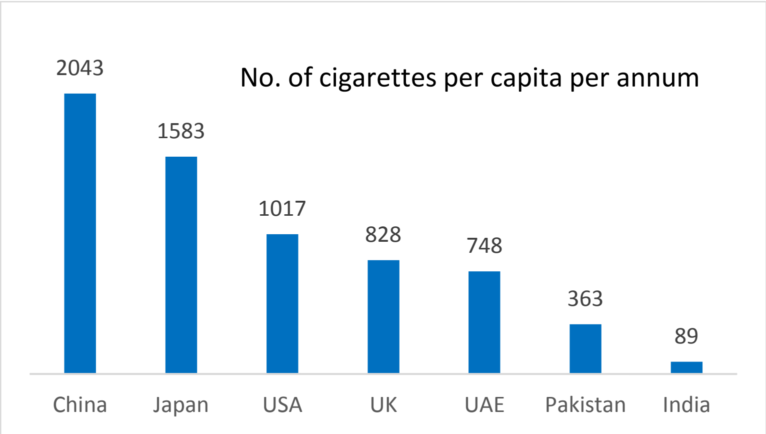
ITC has diversified presence in Branded Packaged Foods, Personal Care, Education and Stationery, Agarbattis & Safety Matches, Lifestyle Retailing, Cigarettes & Cigars, Hotels, Paperboards & Specialty Papers, Packaging, Agri-business & IT.

❖ Investment Rationale:

- **Cigarette Consumption is expected to go up due to following reason:**
  - **Favourable demography and rising urban population**
  - **Government losing revenue due to untaxed tobacco**
  - **Socio-Economic implication from Non taxed tobacco consumption**

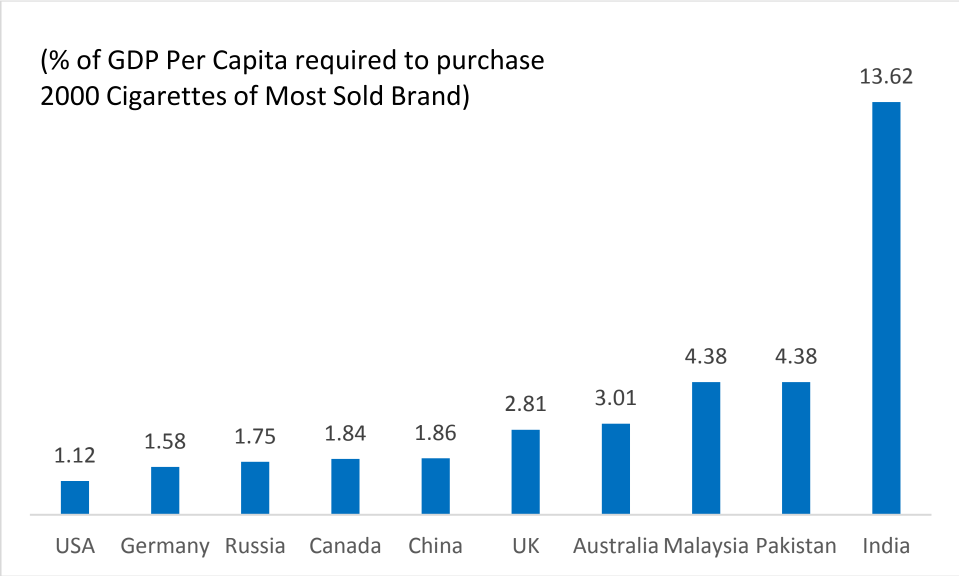
How Indian smokers are stacked up against global smokers:

- Globally cigarette forms 90% of tobacco consumption vs. India's 15% (including 4% by illegal cigarette)
- Global cigarette volumes stand at 5,500bn sticks, while India consumes only ~100bn sticks (including illegal). World per capita cigarette consumption is at 1,000 cigarettes vs. India at only 86 cigarettes
- India houses the 2nd largest smokers in the world at ~100mn users, skewed towards bidi smokers (78mn)



The growing young and urban middle class leading to higher consumption of cigarettes. Growing stress and financial independence has also led to increase in cigarette consumption among the youth population in the last decade. India is home to second highest number of women smokers globally after US. In India, more than 2/3rd of adult males take some form of tobacco, while the percentage of women smoker is fraction of that of male counterpart but that is fast catching up.

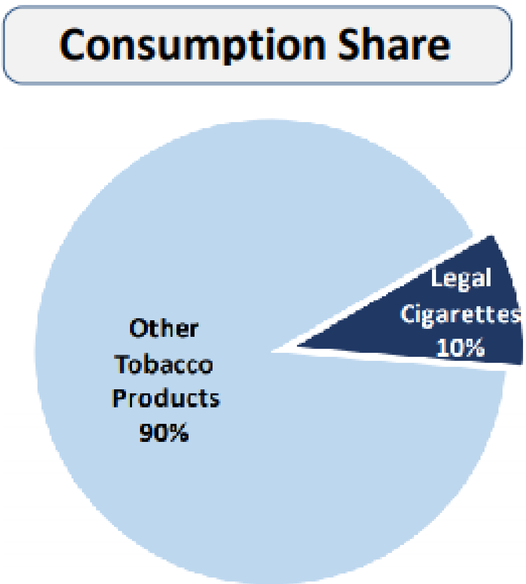
While the legitimate cigarette industry has declined steadily since 2010-11 at a compound annual rate of over 4% p.a., illegal cigarette volumes in contrast have grown at nearly 5% p.a. during the same period, making India one of the fastest growing illegal cigarette markets in the world. As a result, despite accounting for merely 10% of the tobacco consumed in the country, duty-paid cigarettes contribute more than 86% of the revenue generated from the tobacco sector. It is estimated that on account of illegal cigarettes alone, the revenue loss to the Government is more than ` 13000 crores per annum. Excessive taxation has made legal, duty-paid cigarettes in India amongst the costliest in the world in terms of per capita affordability.

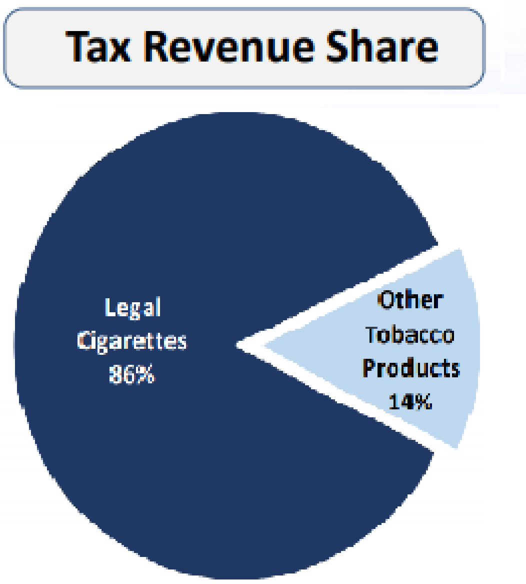


Global illegal cigarette market contributes ~10% of volumes vs. India at 25% (16% in 2010)

Comparison against Bidis: Though, we don't want to push cigarette at the cost of Bidi, but government should take due consideration of the social and economic cost of Bidi consumption in India.

Bidi, a cheap cigarette made of unprocessed tobacco wrapped in leaves is very popular in India, accounting for 81 per cent of the tobacco smoked and 72 million regular users over the age of 15. According to researchers from Centre for Public Policy Research (CPPR), bidi contains less tobacco than conventional cigarettes, however the nicotine content is significantly higher. The relatively low burn point forces smokers to breathe in more of the harmful chemicals produced. Smoking bidi cost India Rs 80000 crore in 2017 alone. Despite overwhelming evidence on the effectiveness of taxing tobacco products, taxation as a tool to regulate bidi smoking has been highly underutilised in India, as the move might be viewed as anti-poor among the voting community.





India is the 2nd largest tobacco producer country in the world. Tobacco occupies a prime place in the Indian economy on account of its considerable contribution to the agricultural, industrial and export sectors. Government policies recently the tax paying cigarette companies have unintended impact on tobacco farmers whose livelihood. This decline in domestic demand, together with lack of export opportunities (favourable prices of competing origins and lower Indian crop) has adversely impacted earnings of the Indian tobacco farmer. It is estimated that in the four years since 2013-14, Indian tobacco farmers have suffered a cumulative drop in earnings of over ` 4000 crores.

Production and Reach: ITC's cigarettes are manufactured in state-of-the-art factories at Bengaluru, Munger, Saharanpur, Kolkata and Pune, with cutting-edge technology & excellent work practices benchmarked to the best globally. An efficient supply chain & distribution network reaches India's popular brands across the length & breadth of the country.

Brands and Product offerings: With more than one hundred years of expertise in developing products to match the evolving taste of the consumers, ITC's cigarette business continues to be relentless in its pursuit of strengthening its leadership position in every segment of the market in India. ITC's wide range of brands, includes Insignia, India Kings, Classic, Gold Flake, American Club, Navy Cut, Players, Scissors, Capstan, Berkeley, Bristol, Flake, Silk Cut, Duke & Royal.

Revenue and margin forecast: We believe the company cigarette volume will be growing at 5% for next few years while the company would be able to raise prices by 3%. The increase in price will be able to take of disproportionate increase in taxation which government may bring up as they would be looking for avenues to increase tax revenue to meet budgetary expenses. In case, the increase in taxes are lower (as the case been in 2018 & 2019), we would see marginal increase in EBIT margin (However, our base case remain EBIT margin will be stable in FY20-22).

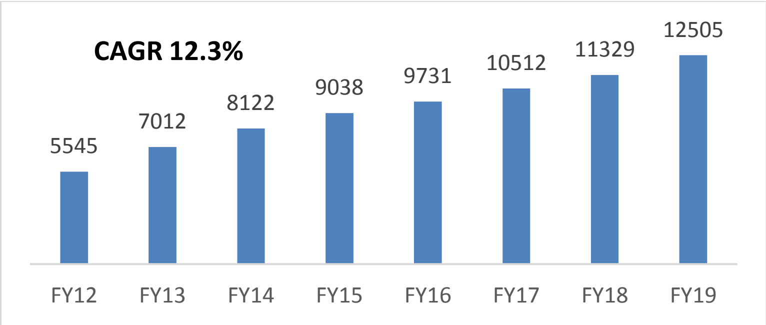
Description	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22
Cigarettes Revenue	34,002	22,894	20,713	22,401	24,227	26,201
Volume growth				5%	5%	5%
Price Inc				3%	3%	3%
EBIT	12,514	13,341	14,551	15,737	17,020	18,407
EBIT margin	37%	58%	70%	70%	70%	70%

EBIT margin prior to FY19 is lower due to VAT regime, Post GST, revenue has been adjusted for GST. Even FY18 include 3months of business under VAT regime.

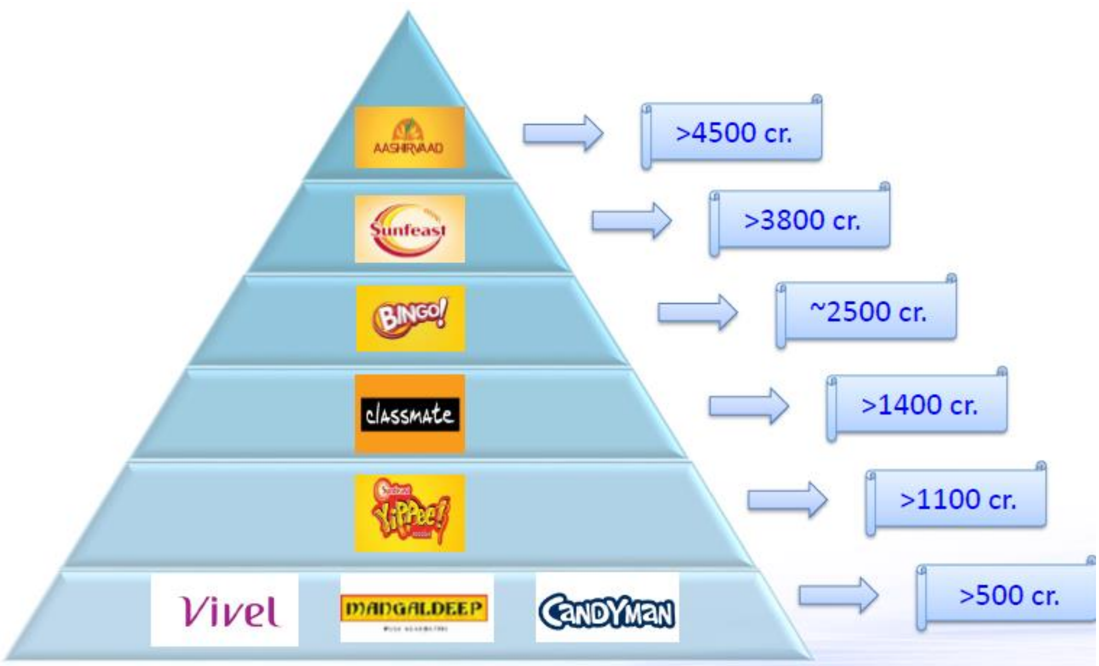
- **Non Cigarette FMCG delivering stable growth:**
  - **Diverse product portfolio with strong brands appeal among customers**
  - **Wide extensive reach to leverage further increase in sales**
  - **Economies of scale gradually trickling in the margin profile**

Consistent growth in revenue from Non Cigarette FMCG: The structural drivers of long-term growth such as rising disposable incomes & consumer awareness, low levels of penetration of consumer goods, favourable demographics and increasing urbanisation amongst others, remain firmly in place which augurs well for the FMCG industry.

Rising incomes and growing youth population have been key growth drivers of the sector. Brand consciousness has also aided demand. Low penetration levels in rural market offers room for growth. Disposable income in rural India has increased due to the direct cash transfer scheme and continued efforts from government to get cash in the hand of rural consumers.



Diverse portfolio brands: Company's vibrant portfolio of brands represents an annual consumer spend of over ` 18000 crores in aggregate. Over 25 world-class Indian brands, have been built largely organically by ITC over a relatively short period of time - a feat unparalleled in the Indian FMCG industry. In terms of annual consumer spend, Aashirvaad, Sunfeast, Bingo!, Classmate, YiPPee!, Vivel, Mangaldeep and Candyman are the leading brands which resonates well with Indian customers. These world-class Indian brands support the competitiveness of domestic value chains of which they are a part, ensuring creation and retention of value within the country.



Growing sales and improving margin: As the revenue from Non Cigarette segment grew consistently, company has turned EBIT positive in this segment for last three years and increasing their margin in the segment by 200basis points every year. We expect FY20 to be slightly lower volume growth at 4% which will pick up again in FY21 and onwards, moderately supported by improvement in realization slightly lower than inflation. As the company grow its revenue above 15000cr in FY21, we anticipate the business will deliver margin expansion and EBIT margin will grow to 7% in FY22.

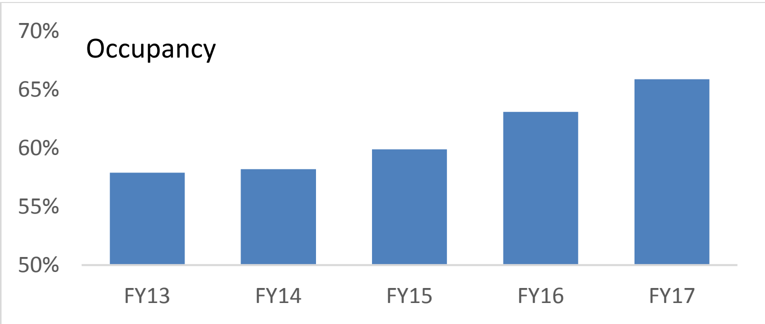
	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22
Non Cigarette FMCG Revenue	10,512	11,329	12,505	13,266	14,347	15,516
Volume growth		8%	10%	4%	5%	5%
Price Inc				2%	3%	3%
EBIT	28	164	316	600	793	1,012
EBIT margin	0%	1%	3%	5%	6%	7%

- **Hotel Industry is proxy to middle and higher middle class consumption in India:**
  - **Favorable demand supply factor for hotel Industry**
  - **Wide range of hotels across different price points**
  - **Increasing domestic tourist leading to higher occupancy for hotels**

Expanding domestic tourism, increasing foreign tourist arrivals, high airline passenger numbers and muted room supply growth has put the Indian hotels industry on an upswing. The recent trends and statistics of the industry as well as improving domestic macroeconomic data suggest the road ahead will bring higher room revenues and profit margins for the hotels industry in the country

ITC Hotels business remains amongst the fastest growing hospitality chains in the country with over 105 properties under four distinct brands – 'ITC Hotels' in the Luxury segment, 'Welcom hotels' in the Upper-Upscale segment, 'Fortune' in the Mid-market to Upscale segment and 'Welcom Heritage' in the Leisure & Heritage segment.

Since there has been limited supply of hotel rooms in last few years, occupancy in the premium hotels are consistently improving over last two years. Since, the room supply remain muted after decent increase in demand, we believe hotel industry is well placed to reap the benefits of favourable demand – supply scenario, leading to higher occupancy and room rent.



ITC remains committed to enhancing the scale of the Business by adopting an 'asset-right' strategy that envisages building world-class tourism assets for the nation and growing the footprint of managed properties by leveraging its hotel management expertise. Managed properties now account for more than 50% of room inventory of ITC hotels group.

Though operationally the hotel business is continuously improving and as the management is converting the business model into asset light, we believe company will be able to garner higher revenue without aggressive investment in assets side. However, return ratios on the hotel business is still expected to remain on lower side in the near future.

	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22
Hotels Revenue	1,342	1,418	1,665	1,865	2,089	2,340
Growth		6%	17%	12%	12%	12%
EBIT	111	140	178	236	307	343
EBIT margin	8%	10%	11%	13%	15%	15%
Assets Value		5,521	6,016	6,137	6,259	6,385
RoCE		3%	3%	4%	5%	5%

- **Domestic demand for paper will be supported by FMCG, Pharma and Publishing**
    - **FMCG, Pharma & Publishing will be key drivers in demand growth**
    - **Companies with weaker balance sheet are closing down, leaving scope for remaining companies to grow their business**

Global demand for Paper & Paperboard is projected to grow at a subdued pace of 1% to 1.5% CAGR driven mainly by Paperboard segment. The growth in the Paperboard segment is expected to be driven by consumer goods, pharmaceuticals and e-commerce. The Writing & Printing and Newsprint segments, on the other hand, are expected to remain under pressure largely due to increasing adoption of digital media and proliferation of smartphone usage.

ITC's Paperboard and Paper business contributes 86% of the segment while rest is led by printed materials. Paper business is also a strategic move for backward integration of the cigarette business. A large portion of this business is being consumed internally.

Paper Industry witnessed strong capex in 2010 – 12, which was mostly funded by debt. Over period of time, companies who have taken too much debt on their balance sheet has to shut shop. This presented opportunities for companies with stronger balance sheet to fill the vacuum.

Over the next five years, domestic industry is projected to grow at 6% CAGR to reach 24 million tonnes by 2024 with Paperboard (54% of the market) and Writing & Printing paper (28% of the market) segments estimated to grow at around 7% CAGR and 5% CAGR respectively.

Paper industry is expected to see some pressure on pricing as the international pulp prices have come down recently and the demand for the paper globally is not expected to become buoyant. We expect, given the closure of other paper mills in India, strong players in India will be able to maintain 5-6% volume growth, while the paper price correction in FY20 will be recovered in FY21 & FY22.

Description	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22
Paper Revenue	5,363	5,250	5,860	5,901	6,444	6,969
Volume growth		-2%	12%	6%	5%	5%
Price Inc				-5%	4%	3%
EBIT	966	1,042	1,239	1,180	1,289	1,394
EBIT margin	18%	20%	21%	20%	20%	20%

- **Agri business, a stagnant business in the overall portfolio**
    - **FMCG, Pharma & Publishing will be key drivers in demand growth**
    - **Companies with weaker balance sheet are closing down, leaving scope for remaining companies to grow their business**

Global production of Flue Cured Virginia (FCV) tobacco registered a further decline of 5.3% in 2018 over the previous year, primarily impacted by continued calibration in China's crop output. After three successive years of decline, Indian crop output in 2018 increased by 6 million kgs. to 218 million kgs. However, it still remains far below the levels of 2014 representing a cumulative drop of over 30%

Extremely high rates of taxes are levied on Cigarettes in India which apart from impacting domestic legal Cigarette industry, has also resulted in significant pressure on leaf tobacco crop.

ITC's agri business is seen as raw material security to tobacco and Non tobacco business. Increase in raw material cost in other businesses can be seen as neutralized by higher margin in this segment.

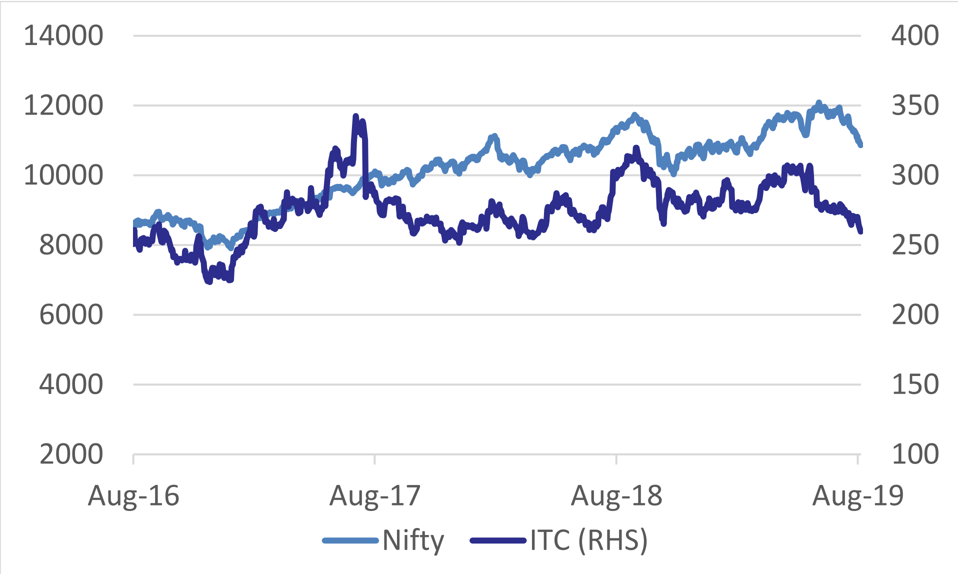
We expected subdued revenue growth from Agri business while the margin will remain stable.

Description	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22
Agri Revenue	8,265	8,068	9,397	9,678	10,162	10,670
Growth		-2%	16%	3%	5%	5%
EBIT	906	849	777	968	1,016	1,067
EBIT margin	11%	11%	8%	10%	10%	10%

Valuation and View:

Given the above thesis, we are optimistic on ITC ltd prospects and accordingly recommend a BUY on the stock. We are valuing the company's share at Rs. 323 based on SoTP valuation for different business verticals of the company, representing a potential upside of 24% from the CMP of Rs. 260. On comparing the price target on P/E approach, ITC is valued at 28x to FY21's EPS of Rs. 11.6 to arrive at our target price. Given the other FMCG companies in the sector, ITC would be the cheapest players among the peer group.

Given the monopoly nature of company's core business and growing brands among the other FMCG segment, we believe that there exists a potential for re-rating in stock's valuation as the company continues to report strong operating numbers. However, we are not factoring in any re-rating for now and built in the case for re-rating once we see government tax neutral stance on cigarettes.



Risks & Concerns:

- One of the biggest concen over ITC is the government stance on cigarette. Government may take punitive tax rates on Cigarette to reduce the consumption. However, historical events have shown that this has only reduced the legal cigarette consumption and fuel the demand for other form of tobacco consumption, which are more harmful.

- ITC has invested significant resources in developing product portfolio in Non Cigarette FMCG space and has been able to scale up the revenue of the business to be among the leader in the space. However, the profitability despite achieving revenue in excess of 12000cr has not been able to create an impact. We are expecting gradual improvement, 300 basis points in next two years. Any slowdown in improvement in margin will dent the EBIT diversification of the portfolio.

- Strong capex plan in Hotels and Agri segment. Though, both the segment contribute handsomely on the overall EBIT of the company, the return ratios on both the segment remain muted. Any substantial investment in Hotel or Agri business will reduce the return ratios and free cash flow for the overall company.

Financials:

Profit & Loss Statement	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22
Total Pre Inter-segment	56,848	45,837	47,464	50,512	54,551	58,873
Other Operating Revenue	1,440	1,525	1,884	2,005	2,166	2,337
Gross Revenue	58,288	47,363	49,348	52,517	56,716	61,210
Excise duty	15,928	4,240	1,509	1,632	1,765	1,909
Expenses:						
Raw material cost	16,049	15,855	17,420	18,354	19,623	20,966
Employee Expenses	3,632	3,761	4,178	4,402	4,706	5,028
Other Expenses	7,660	7,350	8,348	8,795	9,404	10,047
EBITDA	15,019	16,157	17,893	19,334	21,218	23,260
Depreciation	1,153	1,236	1,397	1,487	1,594	1,721
EBIT	13,867	14,921	16,496	17,847	19,624	21,538
Other Income	1,762	1,832	2,174	2,062	2,285	2,501
Interest Exp	24	90	45	47	49	51
PBT	15,604	16,663	18,624	19,862	21,859	23,987
Tax	5,549	5,916	6,314	6,733	7,411	8,132
PAT after exceptional items	10,477	11,493	12,836	13,128	14,449	15,855
Minority Interest	188	221	244	249	274	301
Attributable PAT	10,289	11,271	12,592	12,879	14,175	15,555
EPS	8.50	9.26	10.30	10.53468	11.59429	12.72297
DPS	4.75	5.15	5.75	5.79	6.38	7.00
Pay Out Ratio	56%	56%	56%	55%	55%	55%

Balance Sheet	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22
Share Capital (Net of Treasury)	1,215	1,220	1,226	1,226	1,226	1,226
Total Reserves	45,198	51,290	57,915	62,379	67,291	72,682
Minority	295	334	343	428	521	624
Shareholder's Funds	**46,708**	**52,845**	**59,484**	**64,033**	**69,039**	**74,532**
Financial Liabilities	60	79	82	87	92	98
Other Non Current Liabilities	2,055	2,115	2,221	2,363	2,515	2,676
Total Non-Current Liabilities	**2,115**	**2,194**	**2,302**	**2,450**	**2,607**	**2,775**
Trade Payables	2,659	3,496	3,510	3,698	3,896	4,104
Other Current Liabilities	4,462	5,754	6,502	6,920	7,364	7,837
Total Current Liabilities	**7,121**	**9,250**	**10,012**	**10,618**	**11,260**	**11,941**
Total Liabilities	**55,943**	**64,289**	**71,798**	**77,100**	**82,906**	**89,248**
Fixed Assets	18,946	21,363	22,752	24,213	26,149	28,221
Other Non Current Assets	3,924	3,291	3,210	3,382	3,563	3,754
Financial Assets	6803.24	13,241	14,090	14,844	15,639	16,477
Total Non-Current Assets	29,674	37,895	40,051	42,439	45,351	48,452

Current Investments	10,887	10,569	13,348	15,207	17,003	19,066
Inventories	8,116	7,495	7,860	8,281	8,724	9,192
Sundry Debtors	2,474	2,682	4,035	4,251	4,479	4,719
Cash and Bank	2,967	2,900	4,152	4,359	4,558	4,787
Other Current Assets	1,824	2,748	2,353	2,479	2,612	2,752
Total Current Assets	26,269	26,394	31,747	34,577	37,377	40,516
Total Assets	55,943	64,289	71,798	77,015	82,728	88,968

Cash Flow Statement	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22
PAT (ex OI)	10,535	11,410	13,346	13,128	14,449	15,855
Add: Depreciation	1152.79	1236.28	1396.61	1,487	1,594	1,721
Change in WC	44.38	1736.38	-494.06	-449	-473	-499
Other Adjustment	852	-1,213	-3,622	-487	-507	-528
Cash From Operating Activities	12583	13169	10627	13,679	15,062	16,550
Cash from Investing Activities	-5,546	-7,114	-3,251	-2,948	-3,530	-3,793
Free Cash Flows	7,038	6,056	7,376	10,731	11,532	12,757
Cash from Financing Activities	-7,301	-6,221	-6,869	-8,665	-9,536	-10,465
Parked in Investment				1,860	1,796	2,063
Net changes In Cash	169	-166	75	207	200	229
Opening Cash Balance	173.79	339.41	264.06	339.41	546.0237	745.6084
Closing Cash Balance	342.88	173.79	339.41	546	746	975

Key Ratios	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22
EBITDAM (%)	35%	38%	38%	39%	40%
ROE (%)	23%	23%	21%	21%	22%
ROCE (%)	41%	41%	41%	43%	44%
Receivable days	19	30	30	30	29
Inventory Days	52	59	59	58	57
Payable days	24	26	26	26	25
Total Debt/Equity(x)	-0.25	-0.29	-0.30	-0.31	-0.32
Current Ratio(x)	2.85	3.17	3.26	3.32	3.39
Adjusted P/E Ratio	27.7	28.9	24.77	22.50	20.51
Price/ Book value	6.17	6.36	5.01	4.66	4.32

ANALYST CERTIFICATION

I (Ravindra Bhandari), Research Analyst, author and the name subscribed to this report; hereby certify that all of the views expressed in this research report accurately reflect our views about the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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