

Kaveri Seed Company Ltd.

Stock Idea

MARKET DATA

NSE TICKER	KSCL
Net worth FY17 (Rs in Crs)	1014.3
P/BV Ratio (FY17) (x)	3.2
EPS (FY17) (Rs.)	11.27
Market Price (Rs.)	505
P/E Ratio (FY17) (x)	44.8X
52 Week High (Rs)	708.1
52 Week Low (Rs)	427.4
Market Capitalisation (Rs. Cr)	3337.5

AVERAGE MONTHLY VOLUME ('000)

BSE	53.985
NSE	592.202

SHARE HOLDING PATTERN

Promoter	54.8
FII	15.8
DII	7.83
Public	16.45

RETURN (%)	1M	3M	12M
Kaveri Seeds	-11.9	-17.8	0.02
Nifty	-5.32	0.39	16.3

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Kaveri Seed Company Limited is one of the premier seed companies in the country. It has a strong R&D base for developing quality hybrids of key Indian crops. It produces over 100 high-quality hybrid seeds across field and vegetable crops. KSCL has one of the largest collections of crop germplasm in the country.

Budget allocation to drive growth in agriculture

Budget 2018-19 had a strong focus on improving rural income on a mandate of doubling the income of farmers by 2022. For instance, the minimum selling price of Kharif crops is to be fixed at 1.5 times the cost of produce. Such initiatives create a favourable environment for seed makers such as Kaveri.

Broadened Product Portfolio:

Historically, KSCL has focused on cotton and now it is strengthening its non-cotton business. This will reduce the dependence on cotton and mitigate the risk of low rainfall or uneven monsoon. Thus, the volatility in earnings will reduce. New product contribution went up to 15% of volume in H1FY18.

Firm is also boosting R&D expense; this enhanced R&D spend should result in the development of new products which will further reduce dependence on cotton.

Geographical Expansion:

KSCL has been one of the market leaders in South India and is now focusing on capturing market share in North and Eastern India. The firm also aims to boost exports. Currently it only exports to Bangladesh but it plans to sell in other markets outside India as well.

Focus on supply chain management

KSCL has been focusing on supply chain management to reduce inventory write-downs and boost profitability. As a result, the days inventory has declined from 540 days in FY16 to 500 days in FY17. Better inventory management combined with a good monsoon last year helped in dramatically reducing write-downs by over 51% from 39cr in H1FY17 to 19cr in H1FY18

Established Brand

KSCL is an established brand in an industry which has high barriers to entry. It has built a strong distribution network, loyalty amongst its customers, and strong R&D capabilities. All of these are difficult to replicate

Valuation & View:

KSCL commands a strong brand value in the seeds industry built over a period of four decades and is trusted by the farmers. We like KSCL due to its leadership position in terms of size, strong R&D capabilities and wide distribution network.

We are valuing KSCL on a PE multiple basis. We value the company with a price objective of Rs.490 using a PE multiple of 18x based on FY19E EPS of 27.21.



❖ About the Company:

Kaveri Seed Company Ltd. is one of the largest premier seed companies in the country. Kaveri Seed was started in 1976 and it has built a strong relationship with farmers over the last four decades. Today, it has grown to be India’s largest cotton seed company excluding North India and has 15% market share. The Company is backed by a strong research and development base spread over 600 acres; research is carried out for developing new hybrids for key Indian crops in this space. It has 6 lac square feet of warehouse space spread across multiple locations in India. The seeds manufactured for sales are grown over 50,000 acres, this land is leased from farmers. It has a huge network of over 15,000 distributors and dealers spread across the country with a strong product line of hybrids.

Kaveri has a comprehensive portfolio of high yield hybrid and varietal seeds. The Company’s presence in a broad spectrum of crops helps to meet different requirements of farmers. This has helped it earn tremendous goodwill. Kaveri derived over half of its revenue from the sale of cotton seeds. KSCL occupies the top 5 ranks in a variety of crops such as Cotton, Maize, Bajra, and Rice.

Cotton Seeds	Non- cotton seeds
<ul style="list-style-type: none"> - Contribution to sales- 51% - Market share- 14.4% - Popular brands- ATM, Jadoo. Jackpot, Singha - Strong presence in Telangana, Andhra Pradesh, and Karnataka, and gaining market share in Maharashtra and Gujarat 	<ul style="list-style-type: none"> - Contribution to sales- 49% - Market share: Maize- 11%, Bajra- 9%, and Rice- 4%. - Popular brands: Rice- Supreme Sona, Kaveri- 9090; Maize- Kaveri 225, Candy, Meeta; Bajra- Kaveri Super Boss, KBH 563 - Strong presence in Telangana and Karnataka

Based on FY17 Sales

❖ Industry Analysis

The India seeds sector is currently estimated to be a US\$2 bn market or 4% of the global seed market (as per International Seed Federation) despite it having 11% of the global arable area. The use of hybrid seeds is very low in India- only 25-30% of its farmers buy new seeds every year; the seed replacement rate is <40% of acreage under cultivation

Population is increasing while agriculture crop area has been stagnating leading to declining agricultural area/person. Meeting increased demand for food will be difficult unless crop yields improve sharply as the stagnant land area is leading to sluggish production growth. Increased use of hybrid seeds shall provide the required increase in production. Furthermore, increase in key crop MSPs will attract capital and induce use of hybrid seeds. Importantly, pesticides and seeds drive a considerable improvement in productivity and yields (20-60%) even though they only account for only ~10% of the cost of cultivation. This makes a case for a long-term positive trend in the industry, especially as there is strong underlying demand.

The India seeds industry is currently growing at 12%, much faster than the global seed industry growth of 5%. Penetration of hybrid seeds is high in cotton (>90%) but very low in other crops such as maize and paddy. Corn, paddy and vegetables should drive the next leg of growth for hybrid seeds. Despite high penetration, high-density planting should be a driver for cottonseeds.

Key success factors for a seed company are as follows

- A new successful hybrid takes eight to ten years. Products introduced in the previous year or two determine growth for the next two to three years. Thus, a strong R&D pipeline is essential to drive future growth.
- R&D capability is important for long-term growth. A strong germplasm collection aids in R&D efforts
- A strong distribution network is important to reach the farmers
- Customer trust in the brand needs to be established over time
- Strong working capital management

Kaveri excels in most of these success factors and is working to improve its working capital cycle.



❖ Investment Rationale:

Budget allocation to drive growth in agriculture

The minimum selling price of Kharif crops is to be fixed at 1.5 times the cost of the produce. If market prices are less than the Minimum Support Price (MSP), the government will procure farm produce or ensure that the farmers get the right price. This should increase the income of farmers, enabling them to buy the high quality, premium seeds supplied by KSCL.

The government has allocated Rs 1,400 crore to the Pradhan Mantri Kisan Sampada Yojana; this sum is nearly double the previous allocation of Rs 715 crore. One of the initiatives under this scheme is to provide effective and seamless backward and forward integration for processed food industry by plugging the gaps in supply chain in terms of availability of raw material and linkages with the market. Under the scheme, financial assistance is provided for setting up of primary processing centres/ collection centres at farm gate and modern retail outlets along with connectivity through insulated/ refrigerated transport. This scheme is applicable to perishable horticulture and non-horticulture produce such as fruits and vegetables. Furthermore, in Budget 2018-19, 'Operation Greens' was announced to augment farm supply chain that will help cultivation of tomato, onion and potato. Thus the potential profits from growing vegetables will increase and wastage of vegetables will reduce. This will boost demand of hybrid vegetable seeds.

Access to financing options has become easier for the farmers. In budget 2018-19, the government has hiked the agriculture credit target to 11lac crore. Normally, a farm loan attracts an interest rate of 9%. However, to enable farmers to take short-term farm credit at an affordable rate and help boost farm output, the government has been providing interest subvention. The government is providing 2% interest rate subsidy to ensure that farmers get short-term farm loan of up to Rs 3 lakh at an effective rate of 7% per annum. An additional incentive of 3% is being given to farmers for prompt repayment of loans within due date; thus the effective interest rate for short term loans for farmers is 4%. This initiative should also drive sales of hybrid seeds.

Government has extended a favourable taxation treatment to Farmer Producers Organisations (FPOs); a 100% income-tax deduction from FY19 up to FY24 has been proposed for farmer producing companies with a turnover of up to 100 crore. This will help farmers aggregate their needs of inputs, farm services, processing and sale operations.

Broadened Product Portfolio

So far, the most important contributor of revenue has been cotton. KSCL is strong in Telangana, Andhra Pradesh, and Karnataka and is growing rapidly in Maharashtra and Gujarat. The firm is now carrying out R&D to develop BT cotton for markets in North India. It has also launched a cotton hybrid for Punjab, Rajasthan and Haryana. These new products and the products in the R&D pipeline will aid in the growth of the company.

KSCL has focused efforts towards diversification- reducing dependence on cotton and increasing the revenue share of other field crops and vegetables. Those crops are higher margin than cotton as the government has set a price cap for cotton seeds. Furthermore, a broad product portfolio will reduce the volatility of earnings by enabling the firm to sell different seeds during low or uneven monsoons. KSCL has strengthened the vegetable seed business with increasing investment in R&D, supply chain, marketing and the launch of new products. Vegetable seeds are low-volume and high-value crops and provide a new opportunity for Kaveri to grow and de-risk the business. Vegetable sales grew from 1.5cr previous year to 3.5cr in 9MFY18 and are expected to reach 4cr by year end. Management expects vegetables to grow by 30% to 40% next year

Newly developed products are rapidly gaining market acceptance and are playing a significant role in contributing to the top line. The new products increased from 1% to 18% of volume for hybrid rice and from 3% to 8% of volume for selection rice in Q3FY18. In the same period, the contribution of new products for Bajra jumped from 6% to 14%.

Kaveri currently enjoys a premium position in the market. Thus, a large market i.e. the middle segment is being ignored. The firm is of the opinion that it is tough for the same company to cater to both market segments. Hence, KSCL will set up a subsidiary to focus on the middle market. This will drive revenue and profitability growth in the future.

KSCL has developed varieties of new germplasm. Their gene bank maintains over 8,000 propriety germplasm accessions in field crops and vegetables. This will facilitate genetic enhancement and multidisciplinary crop improvement research programs which will aid the firm in creating new seeds.



Geographical Expansion

KSCL has been strong in Telangana and AP for cotton and in Telangana and Karnataka for maize. It now aims to expand beyond these states and has aggressively been gaining market share in Maharashtra and Gujarat. Going ahead, the firm plans to expand its distribution network in Northern and Eastern India and in Rajasthan.

The firm also plans to expand its export capabilities. It currently only exports to Bangladesh but plans to start exporting to Pakistan, Nepal, Myanmar, and Egypt next year. Also, KSCL does not have the necessary approvals to sell hybrid rice in Bangladesh and is working to get the required approvals.

Focus on supply chain management

Better supply chain management will help KSCL optimize the working capital and boost profitability by reducing wastage and enhancing yield. The firm aims to achieve better supply chain management from the following initiatives-

- Maximize seed yields through an improved production strategy of anticipating seasonal challenges, leveraging different locations and grower bases, and accurately forecasting production volumes through scientific yield estimations
- Sustain established vegetable seed production locations through capable co-operative organizers and skilled seed growers. In addition, firm will explore alternative vegetable seed production geographies to reduce risk of dependence on few locations
- Enrich quality by implementing field quality metrics
- Boost operational efficiency by optimizing procurement, minimizing seed-quality failures, and inventory write-offs. Furthermore wastage is to be reduced by maximizing plant and cold storage capacity and efficient sales return seed management. Capex costs will be reduced by implementing cost-effective completion of projects and maintenance of plants
- Improve logistics planning and execution to deliver products in time to meet customer requirement.

Established Brand

Entry into India's seed industry can be quite challenging with several obstructions. High investments in R&D are required in the industry; the average lead time taken from R&D to commercial introduction of products is seven to eight years. Developing an effective hybrid involves a complicated procedure and various high-value skills are required to choose the right kind of lines. KSCL has developed varieties of new germplasm. Its gene bank maintains over 8,000 propriety germplasm accessions in field crops and vegetables, which facilitates genetic enhancement and multidisciplinary crop improvement research programmes.

Also, a diverse portfolio of seeds requires a wide distribution network across India to reach various markets in the country. KSCL has a dedicated network of 33,000 grower farmers spread across multiple agro climatic zones. It has over 50,000 acres of land under seed production. To get the seeds to the market, KSCL has a strong distribution network of over 15,000 distributors and dealers. Further, any new entrant to the market must first establish its credibility with farmers because farmers will not risk their income on un-established company seeds. KSCL has high credibility with the farmers with 70% year-on year grower retention.

A seed maker also requires well developed storage and processing capabilities. KSCL has 7 state-of-the-art plants across major locations in India with a total average throughput of 100 MT per hour. The plants have seamless equipment for grading, pre-cleaning, cob drying, storage and packing. It also has dehumidified, climate-controlled cold storage facilities with a long-term capacity storage for about 12,000 tons.

Attractively valued among peers

KSCL is compared with peers- Nath Bio-Genes and JK Agri Genetics. KSCL trades at a lower multiple than its peers in spite of its larger size and better margins. KSCL's EBITDA and PAT margin are higher than its peers but its ROE and ROCE are lower than its peers. The lower ROE and ROCE metrics are largely due to current investments acting as a drag on the returns. If we exclude the current investments, KSCL has higher return measures.

On, the negative side, KSCL's cash conversion cycle is much higher than its peers primarily because of the high number of days inventory (501 days compared to 291 and 199 for Nath Biogene and JK Agri respectively). In addition, its fixed asset turnover is substantially lower than its peers.

The stock is currently trading at a PE multiple of 44.8 which is quite high and falls between the trading multiples of its peers. However, adjusting for a one-off expense of 59cr paid to Monsanto to clear back dues, the company trades at a PE multiple of

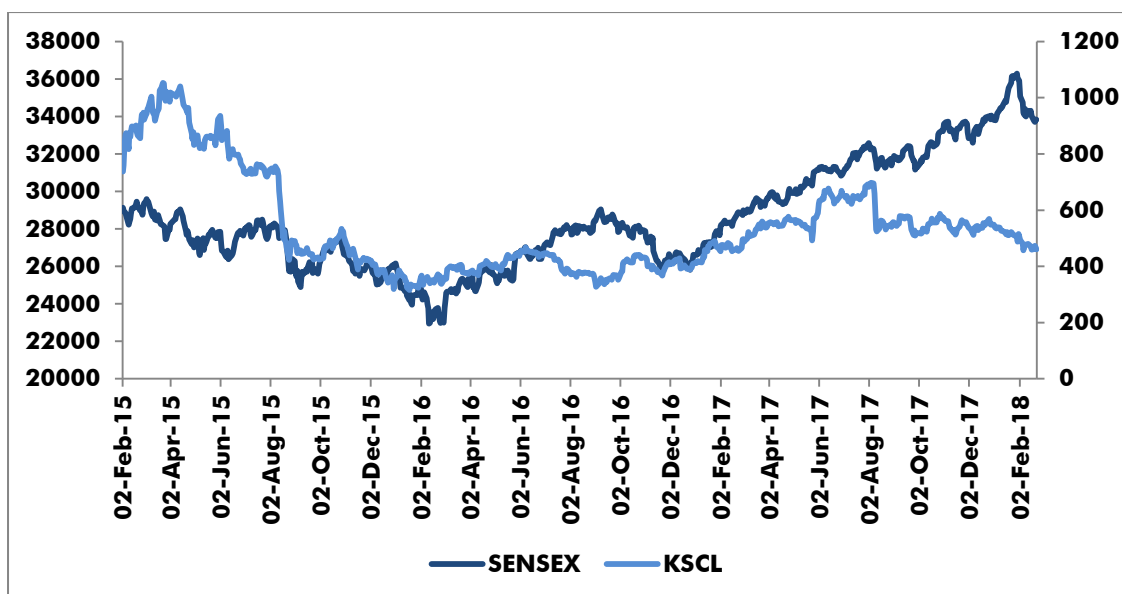


25.44 which is substantially discounted to the peers. Thus, valuation at a conservative forward multiple of 18 for FY19 earnings provides a large margin of safety for purchasing KSCL.

Kaveri Seeds Company Ltd.- Relative Valuation			
Description	Kaveri Seeds	Nath Biogene	JK Agri
Latest Price Date	27-Feb-18	27-Feb-18	27-Feb-18
Latest Market Cap	3338	904	465
Latest Price	505.0	475.0	1290.0
PBIDTM (%)	19.8%	17.4%	14.3%
PATM (%)	19.4%	9.6%	6.3%
ROE (%)	14.3%	12.6%	17.1%
ROCE (%)	10.7%	13.5%	20.2%
ROCE excluding excess cash (%)	30.0%	13.5%	20.2%
Inventory Turnover(x)	0.7	1.3	1.8
Debtors Turnover(x)	8.5	3.5	2.1
Fixed Asset Turnover (x)	1.0	1.9	3.1
Receivable days	43	104	174
Inventory Days	501	291	199
Payable days	262	133	178
Cash conversion cycle	282	263	194
Adjusted PE (x)	25.4	46.7	38.5
Price / Book Value(x)	3.4	6.6	6.1
EV/EBITDA(x)	23.8	32.4	17.7
M Cap / Sales	4.7	5.3	2.4

Source: Dimensional Research

Is the worst over?



Source: Dimensional Research

Kaveri's share price has declined by over 50% from its peak share price of Rs1052 in 2015. This was largely due to its poor performance in FY16 and FY17. KSCL was largely dependent on cotton and revenues and profits declined dramatically in FY16 and FY17 due to poor monsoon causing reduction in acreage under cotton.



Over the last few years, the company has channelized efforts in reducing dependence on cotton. Thus, in the future, if the acreage under cotton will decrease, firm will be able to capitalise on sales from other products such as maize, rice, barley, and vegetables. Furthermore, KSCL has traditionally been strong in South India but weak in other parts of India. Over the last few quarters, the firm has been aggressively growing in Western India (Gujarat and Maharashtra) and it is targeting Northern and Eastern India next. It also plans to expand exports from just Bangladesh to Egypt, Myanmar, Pakistan, and Nepal. These steps will not only provide future avenues for growth but will also protect KSCL from poor rainfall in portions of the country or reduction in cotton acreage.

SWOT Analysis

Strength <ul style="list-style-type: none"> Brand loyalty of the farmers Strong distribution network Strong balance sheet- cash rich company Germplasm built over decades 	Weakness <ul style="list-style-type: none"> Over reliance on cotton Concentrated sales in few key states Dependent on monsoon
Opportunity <ul style="list-style-type: none"> Vegetables and other non-cotton seeds: avenue for future growth Mid-market seeds Geographical expansion to Northern and Eastern states as well as to other countries 	Threat <ul style="list-style-type: none"> SEBI audit- corporate governance issues? Government setting price caps on other seeds Pink bollworm causing decline in sales

Key Financials: KSCL

Source: Dimensional Research

Year ended	Sales	EBIDTA	PAT	EPS	ROCE	ROE	P/E Normalized	EV/EBIDTA
FY17	704.99	173.97	77.29	11.27	10.74%	14.32%	25.44	23.79
FY18E	770.16	232.54	197.83	30.02	16.85%	19.80%	16.82	17.14
FY19E	770.18	212.79	179.27	27.21	13.52%	16.84%	18.56	18.21
FY20E	844.13	244.83	208.98	31.72	13.35%	16.91%	15.92	16.15

Key Risks

SEBI Audit

On 15th December 2015, SEBI appointed M/s. Sarath & Associates, Chartered Accountants, Hyderabad to conduct forensic audit of Kaveri Seeds. KSCL was instructed to provide all records and information required by the CA firm. There haven't been any updates on the audit over the last 2 years and it is still an on-going investigation. Furthermore, in the period 2013-16, SEBI initiated forensic audit only against 2 companies and KSCL was one of them. This suggests that the audit is not a routine examination.

Pink Bollworm Attack

The resistance of genetically modified cotton seeds to the pest- pink bollworm has failed in large portions of Maharashtra. Nearly 35 lac hectares of the total sowing area of 43 lac hectares (over 80%) has been affected. This may have an adverse impact on Kaveri as it gets over half its revenues from cotton. Furthermore, Maharashtra, the state worst impacted by the pest accounts for 32% of KSCL's total cotton sales. However, management is quite bullish about next year cotton sales and expects to grow significantly in Maharashtra and Gujarat and achieve overall cotton volume growth of 15-20%. Our model is more conservative and assumes cotton sales to decline by 10% next year.



Dependence on monsoon

KSCL sales are strongly dependent on monsoons. For instance, during the bad monsoon of FY16, sales and net profit plunged by 36% and 54% respectively. However, the monsoon has been good over the last couple of years and so the farmers are more likely to buy hybrid seeds instead of using their own seeds. Also, a normal monsoon is forecasted for next year which should aid KSCL sales

Valuation & View:

We are valuing KSCL on a PE multiple basis. We value the company with a price objective of Rs. 490 based on a PE multiple of 18x and FY19E EPS of 27.21.

We like KSCL as it commands a strong brand value in the seeds industry built over a period of four decades and is trusted by the farmers. The firm is one of the leaders in Indian seed industry in terms of size, strong R&D capabilities and wide distribution network.

❖ Financials:

Kaveri Seeds Company Ltd.- Statement of Profit & Loss				
Description	FY17	FY18E	FY19E	FY20E
Net Sales	705.0	770.2	770.2	844.1
Expenditure:				
COGS	347.1	371.2	378.8	414.8
Power and fuel cost	7.8	11.6	11.6	12.7
Employee cost	39.9	41.9	44.0	46.2
Other operating expenses	170.7	151.8	153.5	164.9
EBITDA excluding OI	139.5	193.7	182.3	205.6
EBITDA margin	19.8%	25.1%	23.7%	24.4%
Depreciation	30.2	26.4	26.9	27.4
EBIT	109.3	167.3	155.4	178.1
OI	34.4	38.9	30.5	39.2
Interest	0.2	0.4	0.4	0.4
PBT before exceptional item	143.5	205.8	185.5	217.0
Exceptional item	-59.2	0.0	0.0	0.0
PBT	84.3	205.8	185.5	217.0
Provision for tax	7.0	8.0	6.3	8.0
Minority interest	0.5	0.6	0.6	0.7
PAT	77.8	198.4	179.9	209.6
EPS	11.3	30.0	27.2	31.7



Kaveri Seeds Company Ltd.- Balance Sheet				
Description	FY17	FY18E	FY19E	FY20E
Equity Share Capital	13.8	13.2	13.2	13.2
Total Reserves	1000.5	976.3	1133.0	1319.4
Shareholder's Funds	1014.3	989.6	1146.2	1332.7
Minority Interest	-0.7	-1.3	-1.9	-2.6
Total Borrowings	4.6	4.6	4.6	4.6
Other Long Term Liabilities	7.8	7.8	7.8	7.8
Total Non-Current Liabilities	12.5	12.5	12.5	12.5
Trade Payables	281.6	221.9	226.5	248.0
Other Current Liabilities	218.6	236.8	236.8	257.4
Total Current Liabilities	500.2	458.7	463.3	505.4
Total Liabilities	1526.3	1459.4	1620.1	1848.0
Fixed Assets	233.6	251.4	254.3	257.3
Other Non Current Assets	9.1	9.1	9.1	9.1
Total Non-Current Assets	242.6	260.5	263.4	266.4
Current Investments	654.5	513.2	660.5	828.3
Inventories	447.8	509.2	519.6	569.0
Sundry Debtors	85.4	80.6	80.6	88.3
Cash and Bank	21.0	21.0	21.0	21.0
Other Current Assets	75.0	75.0	75.0	75.0
Total Current Assets	1283.7	1198.9	1356.6	1581.6
Total Assets	1526.3	1459.4	1620.1	1848.0

Kaveri Seeds Company Ltd.- Cash flow statement			
Description	Mar-18 E	Mar-19 E	Mar-20 E
PAT	197.8	179.3	209.0
Changes in WC	-98.0	-5.9	-14.9
Depreciation	26.4	26.9	27.4
Cash flow from operations	126.2	200.3	221.5
Cash flow from investment	-44.2	-29.8	-30.4
Dividend and dividend tax	-23.2	-23.2	-23.2
Share buy back	-200.0	0.0	0.0
Free cash flow	-141.3	147.3	167.9
Change in current investments	-141.3	147.3	167.9
Opening investments	654.5	513.2	660.5
Closing investments	513.2	660.5	828.3



Kaveri Seeds Operation Ratios				
DESCRIPTION	FY17	FY18E	FY19E	FY20E
Operational & Financial Ratios				
Earnings Per Share- Normalised (Rs)	19.85	30.02	27.21	31.72
Book Value (Rs)	146.89	149.73	173.43	201.64
Margin Ratios				
PBIDTM (%)	19.8%	25.1%	23.7%	24.4%
EBITM (%)	15.5%	11.7%	12.7%	14.0%
PATM (%)	19.4%	25.8%	23.4%	24.8%
Performance Ratios				
ROA (%)	9.5%	13.3%	11.7%	12.1%
ROE (%)	14.3%	19.8%	16.8%	16.9%
ROCE (%)	10.7%	16.8%	13.5%	13.3%
ROCE excluding current investments (%)	30.0%	34.9%	31.8%	35.2%
Asset Turnover(x)	0.46	0.53	0.48	0.46
Inventory Turnover(x)	0.73	0.73	0.73	0.73
Debtors Turnover(x)	8.51	9.56	9.56	9.56
Fixed Asset Turnover (x)	2.91	2.96	2.92	3.17
Efficiency Ratios				
Receivable days	42.91	38.18	38.18	38.18
Inventory Days	500.67	500.67	500.67	500.67
Payable days	261.71	218.22	218.22	218.22



ANALYST CERTIFICATION

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