

Mastek

Initiating Coverage

Recommendation	:	Market performer
CMP	:	Rs 297
Target	:	Rs 331
Upside Potential	:	11.5%

Sector	:	IT
Sensex	:	17135
Bloomberg code	:	MAST IN
Reuters Code	:	MAST BO

AT A GLANCE

Issued Equity Capital (Cr. Shrs)	:	13.45
Mkt. Cap (Rs. in Crs)	:	798.83
Major Shareholders		
Promoters (%)	:	42.91%
Free Float (%)	:	57.09%
Avg. Daily Vol. ('000)	:	267.43

SHARE PRICE CHART



ANALYST

Sheetal Aggarwal +91 44 2530 7365
sheetala@dbschola.murugappa.com

Building value for long term

Mastek is a pioneer player focused in two verticals – Insurance and Government. The company has substantial experience and intellectual property (IP) in both the verticals. The company derives majority of its revenue from the government vertical (35.7%) followed by insurance (29.4%) while the rest comes from banking & financial services (BFSI). In Life/Health insurance industry Mastek is acknowledged for its enterprise solution offering called Elixir.

The insurance industry is currently ruled by the existing legacy applications which are often unable to keep pace with the continuously evolving nature of the operating environment and demands of the businesses that run them. Thus, it has created a huge market for new technology applications. We believe Mastek with its established presence in the insurance segment is rightly placed to capture the budding demand going forward.

Valuations

The current depression in the economy has dampened company's revenue in FY09 resulting in subdued growth of 5.4%. In addition, the sudden ramp down by the company's largest client NHS punctured the revenue run rate in Q3 and Q4FY09. Consequentially there has been a sharp decline in the company's order book. Currently, Mastek is engaged in launching its SOA-based IP modules which will start delivering outputs within three to four quarters after its expected launch in dec'09.

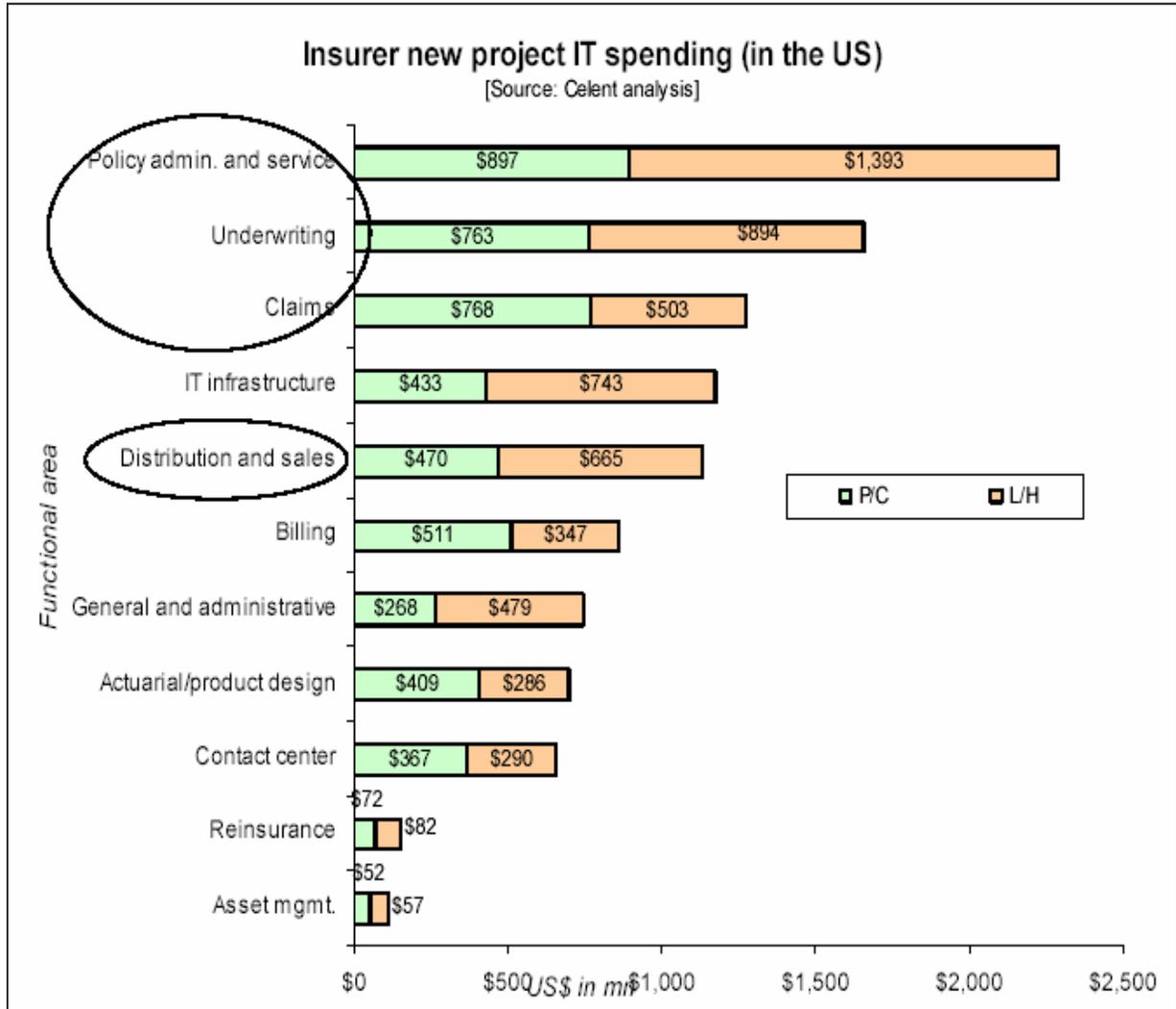
We expect the incremental revenue to kick in starting Q1FY11. We expect a 5% decline in FY10 revenues followed by a recovery in FY11 with growth in revenues at around 11.4% YoY. We initiate coverage on Mastek with a **Marketperformer** rating and a target price of Rs331.

FY June (Rs Crore)	Turnover	EBITDA	Pre-tax Profit	Net Profit	EPS (Rs)	BVPS (Rs)	PE (X)	Net Div Yield (%)	P/BV (X)	ROE (%)
2009	942.6	159.16	147.21	141.2	52.49	189	5.7	7.5	1.59	27.77%
2010E	895.5	155.1	144.9	126.8	47.14	225.9	6.4	7.5	1.33	20.87%
2011E	997.6	179.5	170.9	149.5	55.58	268.5	5.4	7.5	1.12	20.70%

The Insurance opportunity

Insurance, a focus vertical for Mastek, the overall market size for new enterprise application projects in the US alone is estimated to be around US\$11 billion (Exhibit 1). The market for this vertical in the UK is estimated to be about US\$ 4 billion.

Exhibit 1



Source: Company data, DCSEC Research

About 37% of the entire IT spends of US insurers are likely to be on new IT projects distributed between Life/Health and Property/Casualty segment. The rest will be spent on maintenance of existing systems. The functional areas (encircled in Exhibit 1) that are expected to attract most of this new project spending are policy administration and services, underwriting, claims, IT infrastructure, and distribution and sales. Mastek's current focus areas (encircled in the chart above) in the Life segment represent a \$3.5 billion opportunity, for which it intends to have all 4 modules of its new Service Oriented Architecture (SOA)-based Elixir platform ready by the end of the current calendar year.

Investment Summary

Huge prospects from insurance market

Mastek derives almost one third of its revenues from insurance vertical with key presence in UK using the Elixir platform. We expect insurance to remain the main focus area going forward based on Mastek's plan to build its product portfolio and expanding inorganically. The company has already made two strategic acquisitions during FY08 - Vector Insurance Service and STG which helped Mastek in unlocking opportunities in US insurance sector. We expect the insurance vertical to be a strong growth driver and lead the revenue pie by FY11.

In July 2007, Mastek made a key strategic acquisition within its focus insurance vertical in the US. The company acquired 90% equity stake in the company called Vector Insurance Services (Vector). Vector provides policy acquisition, administration, and processing solutions to customers in the North American life insurance industry. Its policy administration system is used by more than 30 life insurers in the United States, Canada and Japan and following the acquisition, Mastek gained access to some of the leading players in the US insurance industry.

In March 2008 Mastek acquired 100% equity stake in Systems Task Group (STG) International Ltd, an IP-based enterprise solutions provider to the North American property & casualty (P&C) insurance industry. STG brought in addition of two IPs in Mastek's portfolio i.e. Renaissance suite and Paradigm ASP now combined as STG suite. Both IPs have successful track record of more than 17 years and over 35 customers that include names like Tokio Marine Management (TMM), GMAC Insurance, RLI Insurance, FCCI Insurance, Amerisure, Bituminous, Max Specialty, and Ford Financials amongst others.

According to Celent estimates, the P&C segment is a high potential market, with IT spending by P&C insurers expected to cross US\$20 billion by 2010 from US\$16 billion in 2007. STG Mastek's IP-led client base and presence in the property & casualty segment combined with Mastek's IP-led capabilities in the life & annuity segment of the insurance vertical, is expected to enable significant leverage across the entire insurance space. Also, the insurance industry currently is ruled by the existing legacy applications which are often unable to keep pace with the continuously evolving nature of the operating environment and demands of the businesses that run them. Thus, it has created a market for new technology applications. The enterprise applications for insurance market are attractive from both the returns as well as size and potential perspectives.

Mastek is launching a new, more flexible version of its IP Elixir by the end of calendar year 2009, based on Service Oriented Architecture (SOA). SOA based modules mean the company can provide either end-to end Elixir solution to a customer or specific components. This would be favorable for Mastek as it can scale up the project after providing a particular module. The company has entered into an agreement with Capita for charging additional license fees where clients want to scale up the module to execute more policy.

Government - diminishing opportunity in short term while building for long run

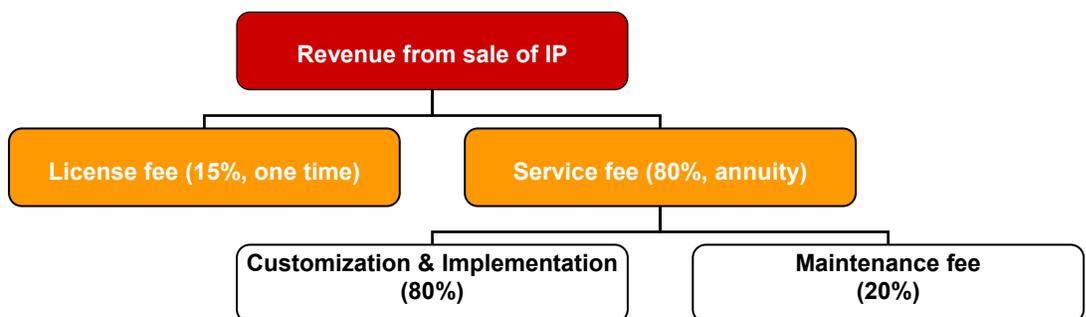
The government constitutes the major part of the revenues. Mastek generally forms part of a bigger consortium whenever competes for assignments in projects that tend to be large and require complex offerings. For example, Mastek has partnered with BT Global Services, to deliver the central database (SPINE) and London LSP programs for the National Health Service (NHS) of the UK. Similarly, the London Congestion Charging project was a ~£600 million project where Mastek partnered with Capita, a UK-based firm, to develop custom-made applications (image management, payment interface, etc) for one of the world's largest .NET project. Recently, the Company entered into a partnership with Thales UK to deliver solutions to meet the Air Movement Operations Capability requirement for the UK's Ministry of Defence (MoD).

However, there are questions on near term growth for this vertical as the company's biggest project NHS provided by BT channel is scaling down and there are no new wins following it. The company entered into a partnership with BT in 2004 to pursue the NHS deal valued around £27mn which later got scaled up to £100 mn. In light of slowdown in new project wins we expect revenues from government vertical to be under concern in FY10. The contribution from this vertical is likely to improve from FY11 as Mastek is actively seeking to develop its ability to team up with such partners and work successfully with them over extended periods..

Managing the entire value chain

Mastek has an IP-led business model which provides it with a strong position in the higher-end of the value chain. This established presence also helps in positioning Mastek in scaling work for other parts of the value chain which too are large and growing. Players with an established position in the higher value segment will tend to have an equally strong presence across the rest of the value chain as a natural consequence. This growth is evident from the fact that Mastek is witnessing improvement in maintenance activities even as it continues to drive growth in the IT solutions sphere.

Exhibit 2: IP-based revenue model



Source: Company, DCSEC Research

Beneficial impact of the vertical focused strategy

Mastek's business model targets the solutions market which works on high gross margins. The business typically has high investments in IP development and brand-building which demand relatively higher sales and marketing as well as R&D costs. Going forward these investments would payoff and will improve the SG&A-to-sales ratio by way of winning new customers and adding incremental revenues. The company has been witnessing a fall in SG&A-to-sales from about 29% in FY2006 to about 26% in FY2009 due to its vertical focused strategy. We expect further improvement in this ratio as the respective verticals attain maturity and reach optimal levels. Improvement in SG&A-to-sales is also likely to lead earnings upsides resulting from margin expansions.

Building partnerships and developing strategic relationships

Mastek has an established track record of collaborating with leading system integrators such as Capita, BT Global Systems, and Thales for co-creating and delivering projects to end-customers. The Company is actively seeking to develop its ability to team up with such partners and work successfully with them over extended periods. During FY2008, the Company initiated an IP ('Swift2Move') based solution implementation for the UK Ministry of Defence in partnership with Thales UK. At the same time the Company is in the process of strategically streamlining its client portfolio from several multi-industry, technology-centric accounts to around 30- 40 accounts over the next couple of years. The company will be maintaining its focus areas of government, insurance and related financial services. This is likely to further enhance the contribution of fixed-bid contracts to total revenues and revenues per client going forward. The company currently derives more than 50% of its revenues from fixed bid contacts.

Considering strategic acquisitions for growth

The Company is also exploring opportunities for inorganic growth to not only scale up its operations but to gain skill-sets, capabilities, and clients that suit Mastek's existing strengths. The target market for the strategic acquisitions would remain in its defined verticals. In line with this strategy, Mastek acquired the US-based Vector Insurance Services in July 2007 and STG International in March 2008. Vector provides policy acquisition, administration, and processing solutions to customers in the North American life insurance industry. Among its customers are two of America's largest insurance carriers that have chosen Vector as their service provider of choice. STG is an IP-based enterprise solutions provider to the North American property & casualty (P&C) insurance industry with annual revenue of \$ 17mn. This acquisition expands Mastek's presence into the non-life segment of insurance vertical. Going forward, we expect these transactions to strengthen the opportunity pipeline for Mastek in the Insurance vertical. The Company already has a growing market presence and has developed an intellectual property (Elixir). Mastek continues to evaluate value accretive opportunities for inorganic growth. The company is targeting players operating in the solutions space with a track record in the state or local government space or in the insurance vertical.

Financials

Gross margins among highest compared to industry

Mastek enjoys premium pricing over players in the services segment as a risk component is built into the fixed-bid contracts it undertakes. Consequentially, Mastek's gross margins are higher relative to most of the Indian IT sector players (Exhibit 3). However, due to the more intensive pre-bid effort that Mastek puts in, and its higher on-site sales, marketing, and account management expenses – which most other Indian players do not incur – the sales, general, and administrative (SG&A) cost for the Company is high.

Exhibit 3

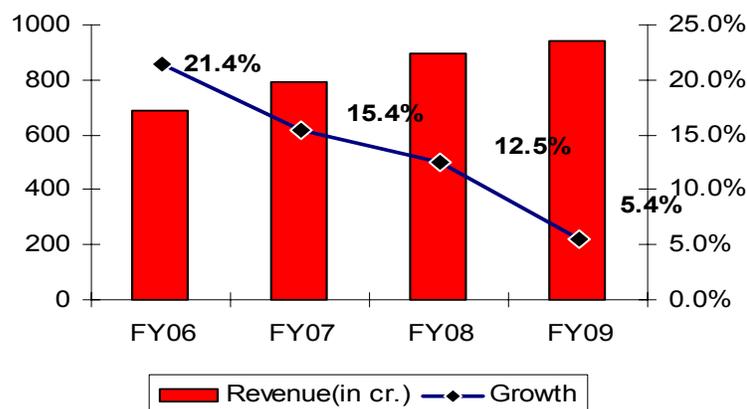
	Mastek (consol. FY2009)	Indian large-tier	Indian mid-tier	Int'l peers
Gross margin	43%	30%-46%	35%-38%	21%-58%
SG&A-to-revenue	26%	13%-21%	17%-21%	6%-25%
EBITDA margin	17%	16%-33%	11%-19%	11%-24%
Net profit margin	15%	14%-28%	5%-14%	3%-11%
Revenue per employee (US\$)	50,038	47,153-61,512	31,715-39,466	135,095-225,895
EBITDA per employee (US\$)	8,455	10,001-15,773	4,214-5,367	22,542-42,655
Profit per employee (US\$)	7,484	8,316-13,126	2,021-4,479	6,051-17,560

Source: Company, DCSEC Research

Growth in revenues to be submissive in FY10

The company has been seeing a decline in revenue growth majorly on account of loss of incremental wins from some of its large accounts and current economic slowdown. The NHS ramp down was the biggest set back on the revenues of last couple of quarters of FY09. We expect revenues to be submissive in FY10 in light of the above mentioned circumstances. However the revenues are likely to start inching up from Q1 FY11 followed by launch of company's more competitive SOA based IP- Elixir.

Exhibit 4



Risk and Concerns

High Client concentration

Mastek has strategic accounts with relatively fewer customers due to its high vertical focus compared to players in the services segment exposing to high client concentration risk. The company's top 5 client's account for more than 55% of the revenues while top 10 client's account for 71% of the revenues. Company's government vertical has already been suffering on absence of incremental work from NHS project. The project was contributing more than 10% of the company's total revenues.

Exhibit 5

Client concentration	Q4FY09	Q3FY09	Q4FY08
Active Clients	87	88	90
Additions	2	2	4
% of Revenue - Top 5 Clients	57%	58%	62%
% of Revenue - Top 10 Clients	71%	73%	76%
Clients accounting for >5% of Revenue	4	6	6
Repeat Business %	99%	98%	98%
No. of Fortune 1000 Clients	21	21	23
No. of Clients with potential of Annual Billing > USD 1 mn	32	33	39
% of business from Clients with potential of Annual Billing > USD 1 mn	91%	90%	94%

Plummeting order book

Mastek's order book has been declining for the past three quarters which was earlier growing in the range of 10-15%. The company's order book stand at Rs 300 crore as on 30th June 2009 which will be executed over the next 12 month period. Also, Mastek's 65% work done is dependent on discretionary spend while only 35% is maintenance work. Since the global economic slump, the discretionary spend by IT companies was the worst hit. This high exposure in discretionary work also poses a threat to the order book.

Valuations

The current depression in the economy has dampened company's revenue in FY09 resulting in subdued growth of 5.4%. In addition, the sudden ramp down by the company's largest client NHS punctured the revenue run rate in Q3 and Q4FY09. Consequentially there has been a sharp decline in the company's order book also. Currently, Mastek is engaged in launching its SOA-based IP modules which will start delivering outputs within three to four quarters after its expected launch in dec'09. We expect the incremental revenue to click in starting Q1FY11. We expect a 5% decline in FY10 revenues followed by a recovery in FY11 with growth in revenues at around 11.4% YoY. We initiate coverage on Mastek with a **Marketperformer** rating and a target price of Rs331.

Company Background

Incorporated in 1982, Mastek is a leading IT player with global operations providing enterprise solutions to businesses and governments worldwide. The Company operates at the higher end of the IT value chain, building strategic applications for customers that enable them implement their business innovations, compete more effectively, operate more efficiently, and become more profitable.

Mastek is having its operations in the U.S, Europe, Canada, Middle East and Asia Pacific with employee strength of over 3700 people. Company's vertical focus includes Insurance (Life, Pensions and General), Government/ Public Sector, and Financial Services sectors. Mastek has substantial experience and intellectual property in all these verticals. The offering portfolio also includes business and technology services comprising of IT Consulting, Application Development, Systems Integration, Application Management Outsourcing, Testing, Data Warehousing and Business Intelligence, Application Security, CRM services and Legacy Modernization.

The company has crystallized its focus on two verticals – Insurance and Government – in which it has substantial experience and intellectual property. The company derives majority of its revenue from the government vertical (35.7%) followed by insurance (29.4%) while the rest comes from banking & financial services (BFSI). In Insurance vertical company is acknowledged for its enterprise solution offering called Elixir. A new, more flexible version of Elixir will be introduced by the end of calendar year 2009, based on Service Oriented Architecture (SOA).

Company has been consolidating its position as an IP-led solutions provider. In July 2007, Mastek made a key strategic acquisition within its focus Insurance vertical in the US, taking a 90% equity stake in the Vector Insurance Services (Vector). Vector provides policy acquisition, administration, and processing solutions to customers in the North American life insurance industry. Its policy administration system is used by more than 30 life insurers in the United States, Canada and Japan and following this acquisition, Mastek will gain access to a reference clientele that includes some of the leading names in the US insurance industry. In March 2008 Mastek acquired 100% equity stake in Systems Task Group (STG) International Ltd, an IP-based enterprise solutions provider to the North American property & casualty (P&C) insurance industry. STG comprise of an IP that has a successful track record of more than 17 years and over 35 customers.

Exhibit 6: Revenue Distribution FY09A

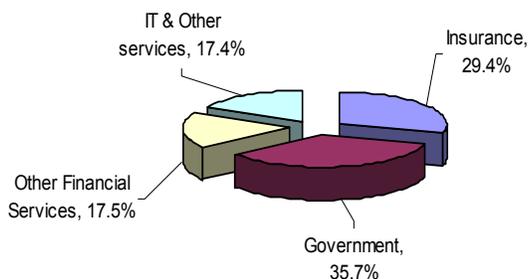
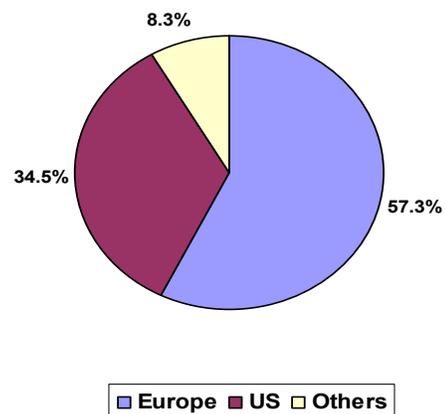
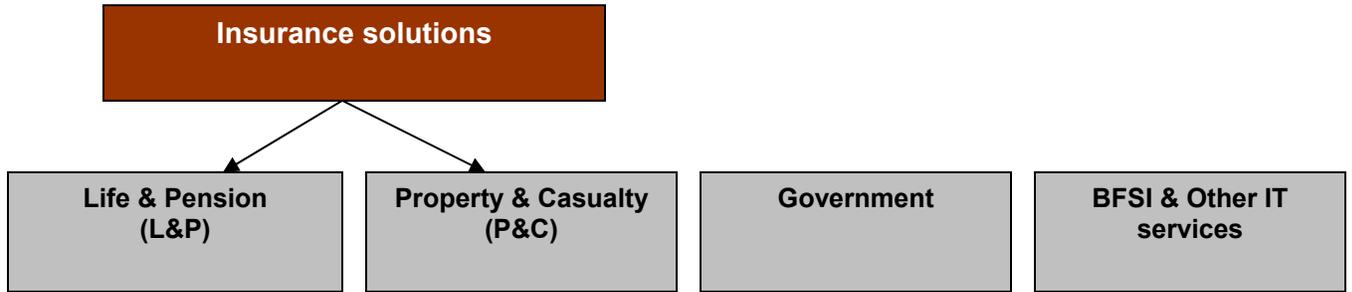


Exhibit 7: Geographical revenue Distribution FY09A



Source: Company data, DCSEC Research

Exhibit 8: BUSINESS MODEL



PRODUCT/ IP OFFERING

<p>Distribution Management</p> <p>Policy Administration</p> <p>New Business Underwriting</p> <p>Claims Processing</p>	<p>Billing & AR</p> <p>Policy Administration</p> <p>Point of sale</p> <p>Claims Administration</p> <p>Distribution Management</p>	<p>Public Sector</p> <p>Military & Aerospace</p> <p>Healthcare</p> <p>Traffic Management</p> <p>Education</p> <p>Welfare</p>	<p>Financial services</p> <p>Wealth Management</p> <p>Brokerage/Capital Markets</p> <p>Asset Management</p> <p>Fund Administration</p> <p>Technology/IT/ Portals</p>
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SOLUTION OFFERING

Custom Application Management
Business Framework
System Integration & Rationalization
Strategic Application management
Legacy modernization

Financial Statements (Consolidated)

Income Statement

FY June (Rs Crore)	FY08	FY09	FY10E	FY11E
Turnover	894.0	942.6	895.5	997.6
Employee expenses	503.37	554.41	536.75	589.01
<i>As % of sales</i>	56.3%	58.8%	59.9%	59.0%
SG&A (incl of other expenses)	230.78	229.03	203.60	229.06
<i>As % of sales</i>	25.81%	24.30%	22.74%	22.96%
Expenses	734.2	783.4	740.4	818.1
Operating Profit	159.8	159.2	155.1	179.5
Other Income	22.2	22.4	22.4	22.4
Interest	3.6	4.8	3.0	1.5
Depreciation	32.5	29.5	29.5	29.5
PBT	145.9	147.2	144.9	170.8
Tax	20.0	6.0	18.1	21.4
Extraordinary Income	-0.9	0.0	0.0	0.0
PAT	125.9	141.2	126.8	149.5
Sales Growth (%)	12.53%	5.44%	-5.00%	11.40%
EBITDA Growth (%)	23.39%	-0.42%	-2.55%	15.73%
EBIT Growth (%)	4.65%	1.65%	-2.67%	16.49%
Effective Tax Rate	13.73%	4.08%	12.50%	12.50%

Balance Sheet

FY June (Rs Crore)	FY08	FY09	FY10E	FY11E
Share holders Equity	13.53	13.45	13.45	13.45
Reserves and Surplus	381.07	495.04	594.2	708.7
Total Debts	87.82	70.38	45	12
Current Liabilities	273.23	226.23	223	249
Total Liabilities	755.65	805.1	875.65	983.15
Net Block	224.98	249.61	272.06	291.66
Capital WIP	21.91	36.92	18.52	9.25
Investments	79.72	101.37	101.37	101.37
Current Assets	418.57	394.63	461.13	558.3
Net Deferred Tax	10.47	22.57	22.57	22.57
Misc. exp not w/o	0	0	0	0
Total Assets	755.65	805.1	875.65	983.15

Cash flow statement

(Rs Crore)	FY 08	FY 09	FY 10E	FY11E
Operating profit before Tax	189.6	179.5	177.9	211.5
Other Income	22.21	22.37	22.37	22.37
Tax paid	22.68	28.62	18.1	21.4
(Inc)/Dec in WC	51.94	-63.52	41.27	4.9
Cash from operations	92.8	192.0	96.2	162.9
(Inc)/Dec in FA	153.32	78.3	34.04	49.47
Other Income	22.21	22.37	22.37	22.37
Cash from investment	-131.11	-55.93	-11.67	-27.10
Increase in Equity including premium	-55.35	-0.5	-0.9	-8.3
Inc/(Dec) in debt	87.45	-17.44	-25.38	-33
Interest Paid	3.6	4.78	3	1.5
Div Paid	27.58	26.79	26.79	26.79
Cash from financing	0.92	-49.49	-56.05	-69.54
Net flow	-37.39	86.58	28.46	66.27
Opening Balance	89.4	52.01	138.59	167.05
Closing Balance	52.01	138.59	167.05	233.32

DBS Cholamandalam Securites Limited

Member: BSE, NSE, MSE

Regd. Office: Dare House, 2 (Old # 234) N.S.C. Bose Road, Chennai – 600 001.

Website : www.choladbsdirect.com**E-mail id - customercare@dbschola.murugappa.com**To open Trading Account **SMS CDWM TA** to 55050

SECURITIES

LOCATION	BEM	PHONE NUMBERS	E-MAIL ID
AHMEDABAD	Mr.Mehul M Min	079 - 64500318/19	mehulmm@dbschola.murugappa.com
BANGALORE	Mr. Sajesh M	080- 41503340/41	sajeshm@dbschola.murugappa.com
	Mr. Krishna Kumar R M		krishnakumarrm@dbschola.murugappa.com
CHANDIGARH	Mr. Vishal Arora	0172 - 26248051	vishalarora@dbschola.murugappa.com
CHENNAI	Mr. Baskaran S	044 - 26198919/16	baskarans@dbschola.murugappa.com
	Mr. M Sundaresan	044- 25307306	sundaresanm@dbschola.murugappa.com
COCHIN	Mr. Preethi Damiyam	0484- 3073859	preethid@dbschola.murugappa.com
COIMBATORE	Mr. Mohan V N	0422- 4292041	mohanvn@dbschola.murugappa.com
DELHI	Mr. Kunal Kaushish	011- 66134224/25	kunalkaushish@dbschola.murugappa.com
HYDERABAD	Mr. Anupam Periwal	040- 64550572/77	anupamp@dbschola.murugappa.com
	Mr. Srinivasa Reddy D V	040- 23316567/68	srinivasardv@dbschola.murugappa.com
JAMSHEDPUR	Mr. Amit Kumar Mahto	0657 - 2320098/177	amitkumarm@dbschola.murugappa.com
KOLKATA	Mr. Kumar Gaurav	033- 44103638/36395	kumargaurav@dbschola.murugappa.com
	Mr.Subhrodeep Chatterjee		subhrodeepc@dbschola.murugappa.com
MUMBAI	Mr. Navneet Kedia	022- 66156591	navneetk@dbschola.murugappa.com
	Ms Shweta Shantaram Padhey	022- 66574000	shwetasp@dbschola.murugappa.com
	Ms. Sheetal Bheda	022 -22153610	sheetalbhedad@dbschola.murugappa.com
PATNA	Mr.Sanjay Kumar	0612 - 2500008	sanjaykumarr@dbschola.murugappa.com
PUNE	Mr. Sujit Arvind Gaidhani	020 - 30264811/12	sujitag@dbschola.murugappa.com
RANCHI	Mr. Sanjiv Kumar	0651 - 6453496	sanjivkumar@dbschola.murugappa.com

REGIONAL EQUITY MANAGER

CHENNAI	Mr. Lakshmanan T S P	9840019701	lakshmanantsp@dbschola.murugappa.com
EAST & WEST	Mr. Ananthanarayan	9930103070	ananthanarayanj@dbschola.murugappa.com
NORTH	Mr. Ajay Kumar Minocha	9838074353	ajaykm@dbschola.murugappa.com
SOUTH	Mr. Shankar P V	9840494132	shankarpv@dbschola.murugappa.com

RESEARCH

Mr. Sandip Raichura	Head of Equities	044-25307216	raichuraS@dbschola.murugappa.com
Mr. Alagappan A	Banking & Financial Services	044-25307204	alagappana@choladbs.murugappa.com
Mr. Rohith Thomas Mathew	Metals, Tea	044-25307363	rohithm@dbschola.murugappa.com
Mr. Ramasubramaniam P	Telecommunication	044-25307360	ramasubramanianp@dbschola.murugappa.com
Ms. Sheetal Aggarwal	Information Technology	044-25307360	sheetala@dbschola.murugappa.com
Mr. Radhakrishnan.R	Technicals	044-25307353	radhakrishnanR@dbschola.murugappa.com
Mr. Kumar Rahul Chauhan	Sugar	044-25307364	kumarrc@dbschola.murugappa.com
Mr. Balajee Tirupati	Derivatives	044-25307364	balajeet@dbschola.murugappa.com
Mr. Balaji Natraj	Strategy	044-25307361	balajin@dbschola.murugappa.com
Mr. Sathyajith N	Mutal Fund Analyst	044-25307225	sathyajithn@dbschola.murugappa.com

COMPLIANCE

Mr Guruswamy Raj	Manager-Compliance		guruswamyrg@dbschola.murugappa.com
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