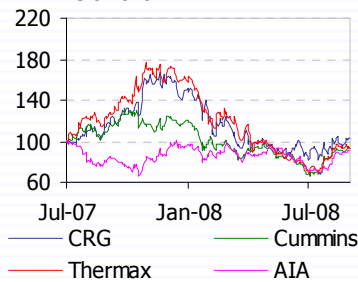
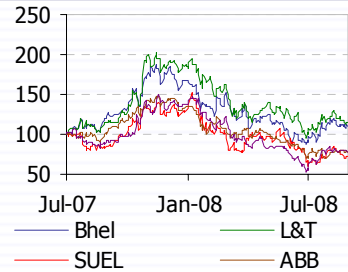


## Relative Performance



Source: ENAM Research, Bloomberg

# Engineering Sector

How far are we from cyclical trough prices?  
Evaluating stress case values!

## Sector summary

Company (%)	Price (Rs.)	Mkt cap (USD mn)	EPS (Rs.)		P/E (x) FY09E	Tgt Price (Rs.)	(% upside)	Rel To to Sec
			FY09E	FY10E				
BHEL	1,732	19,363	69	80	25	1,295	(25)	UP
L&T	2,616	17,470	105	130	25	2,605	(0)	N
Suzlon	225	7,715	9	16	24	-	-	UR
Siemens	547	4,215	23	27	23	540	(1)	N
ABB	874	4,147	30	39	29	-	-	UR
Crompton	256	2,144	14	19	18	300	17	OP
BEL	971	1,774	110	130	9	1,300	34	OP
Cummins	315	1,426	19	23	16	340	8	OP
Thermax	486	1,324	25	31	19	460	(5)	N
AIA Engg	1,571	674	97	122	16	1,500	(4)	N

## Stress Case Valuation

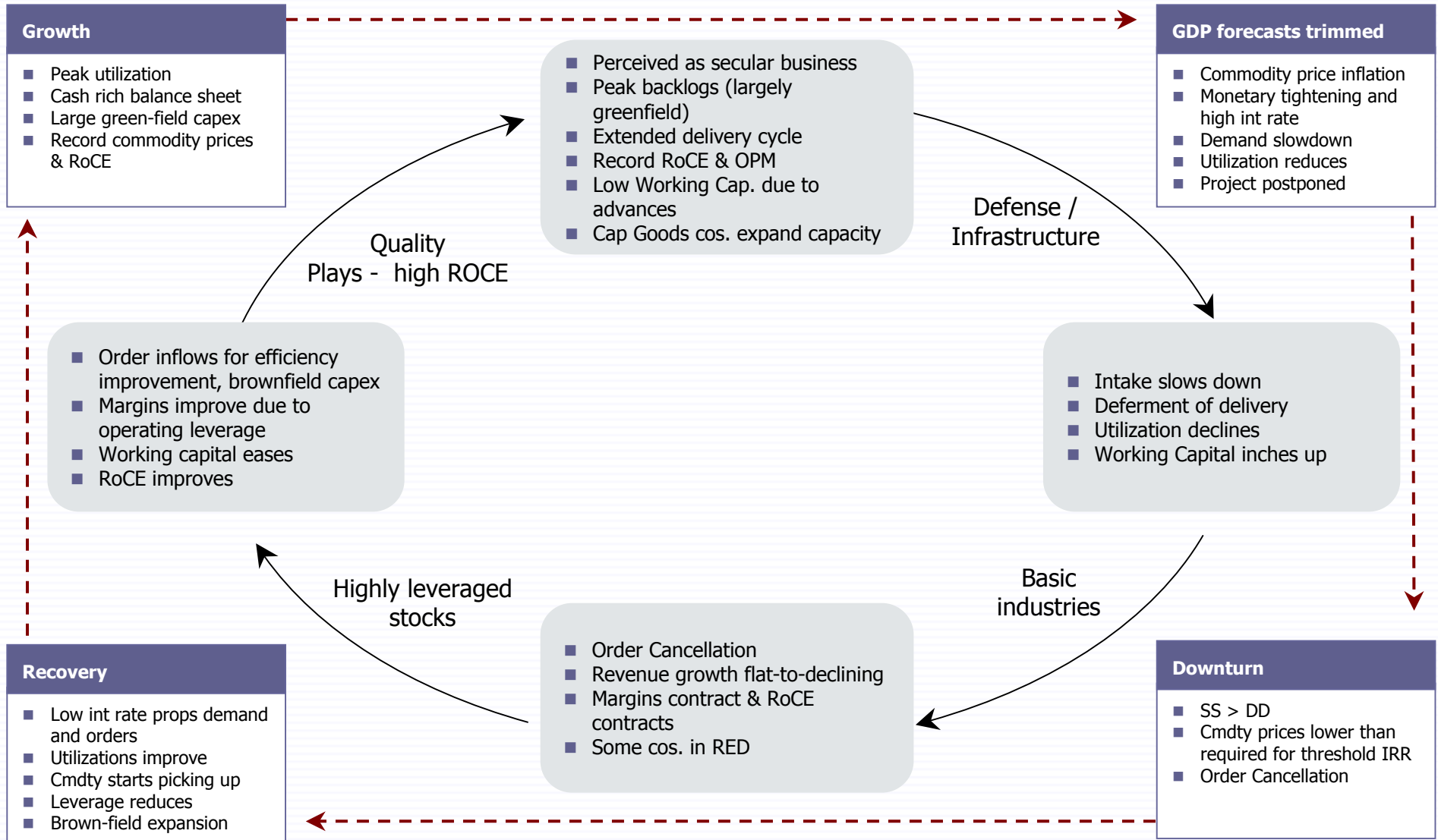
P/E	P/B	EV/Backlog	Average (Rs/share)	52w Low
1,242	801	1,203	<b>1,082</b>	1,325
1,924	1,746	1,468	<b>1,712</b>	2,100
167	225	N.A	<b>196</b>	175
431	391	385	<b>402</b>	359
546	425	505	<b>492</b>	711
187	160	180	<b>176</b>	195
1,097	883	840	<b>940</b>	798
272	240	N.A	<b>256</b>	225
357	260	385	<b>334</b>	331
1,452	1,254	N.A	<b>1,353</b>	1,044

Source: Company, ENAM Research, Note: Prices as on Sept 5, 2008; OP=Outperformer, N= Neutral, UP= Underperformer, UR = Under Review

# Executive Summary

- **We have attempted an exercise, using a range of methodologies to arrive at high comfort - zone entry points for stocks under coverage**
- **Engineering sector: cyclical slowdown in a secular growth phase**
  - Monetary tightening & pre-electoral period may result in capex deferment and slowdown in order intake growth
  - Rising cost and challenges in execution (land acquisition, long lead time for supply of equipment, price control, etc.)
  - Current RoEs could contract, as engineering companies are in significant capex mode
  - We believe that this cycle is different and sustainable RoE's are likely to be higher than in the previous down-cycle due to low/negative leverage and strong operating cash flows of user industry as well as engineering
- While we continue to be in a growth phase, the cyclical slowdown is still not factored in the current valuations. The implied earnings growth for a 50-100% upside over next 3 years, is 30-60% p.a., which is unlikely.
- We believe P/E (based on a sustainable RoE), P/BV (based on a LT growth and cost of equity) and EV/order backlog (based on historical mean) are most suited for valuing engineering companies
- **Based on our stress value calculations:**
  - Stocks far above stress value (>30%) – BHEL, L&T, ABB, Crompton and Thermax
  - Stocks above stress value (10 - 30%) – Suzlon, Siemens, Cummins and AIA Engineering
  - Stocks near stress value (<10%) – Bharat Electronics

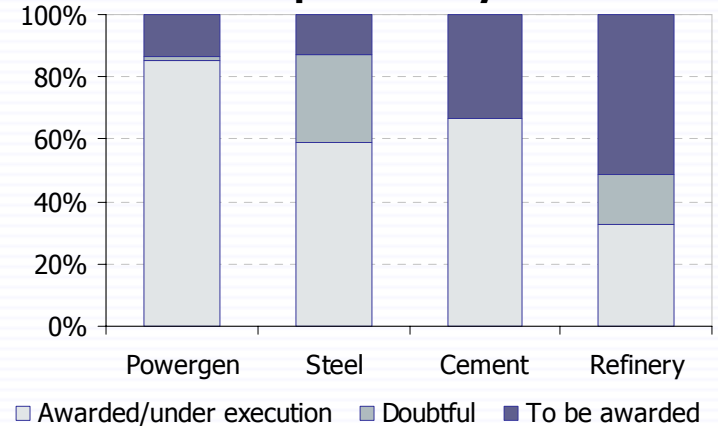
# Capital Goods : A cyclical business



# Where are we in the cycle?

- ➔ **Uncertainty over demand growth**
  - Monetary tightening & rising interest rates
  - GDP growth now slowing dramatically ie ~200 bps to ~8% in 2009E from 9.6% in 2007
  
- ➔ **Economics of greenfield not as attractive**
  - Government intervention in pricing to control inflation i.e. Oil, Cement & Metals
  - Inability to pass on rising feedstock prices – crude oil, iron ore, coal, etc
  
- ➔ **Difficulties in greenfield expansion**
  - Hurdles in acquiring land & feedstock linkages
  - Rising delivery lead times due to tight capacity at equipment suppliers
  - Rising equipment prices and interest rates
  
- ➔ **Delay in Infra capex**
  - Political uncertainties & regulatory hurdles
  - Mounting fiscal deficit
  - Developers facing cash crunch

**Capex Spree: 60-80% of near term capex already awarded**



**Economics of a new cement plant**

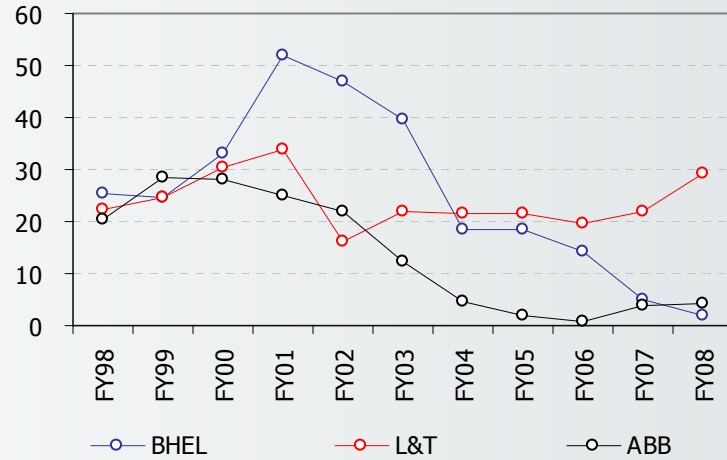
Rs/tonne	Historical Capital cost	Current capital cost
Capital Cost	3,000	5,200
Net Realization	3,200	3,200
<b>Total Cost</b>	<b>2,200</b>	<b>2,200</b>
EBITDA	1,000	1,000
Depreciation	150	260
EBIT	850	740
Interest *	0	312
PAT	570	287
ROCE (%)	28	14
RoE (%)	38	11

Source: ENAM Research, Industry, \* 1:1 D:E & interest @ 12% p.a.

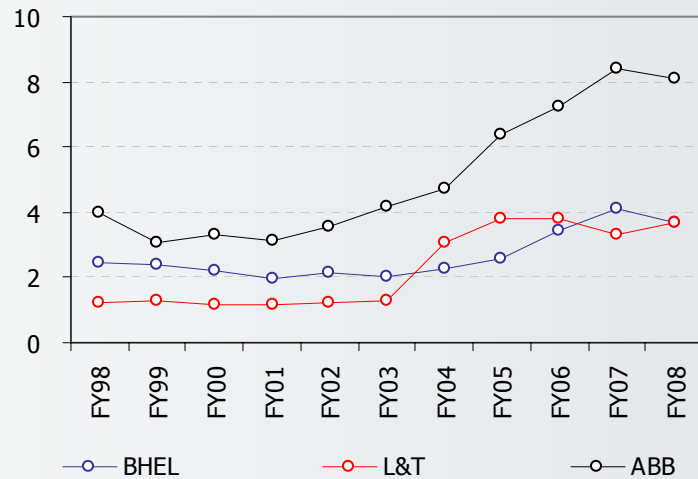
**Macro signs are pointing towards slowdown in order inflows**

# Engg: Efficiency far better over the last cycle

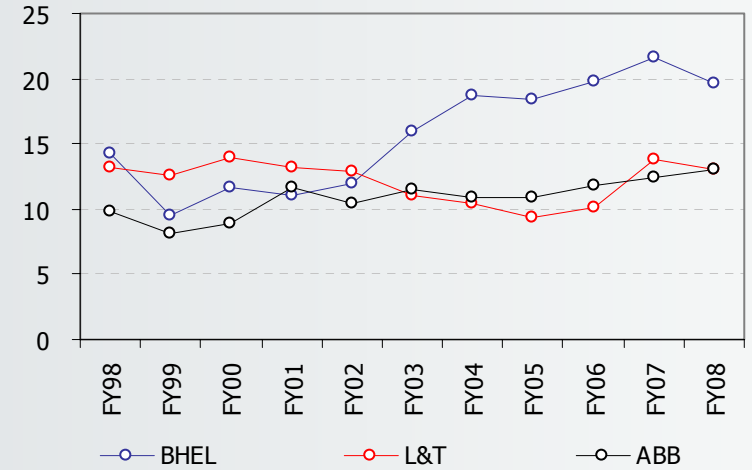
### W. Capital Intensity (%)



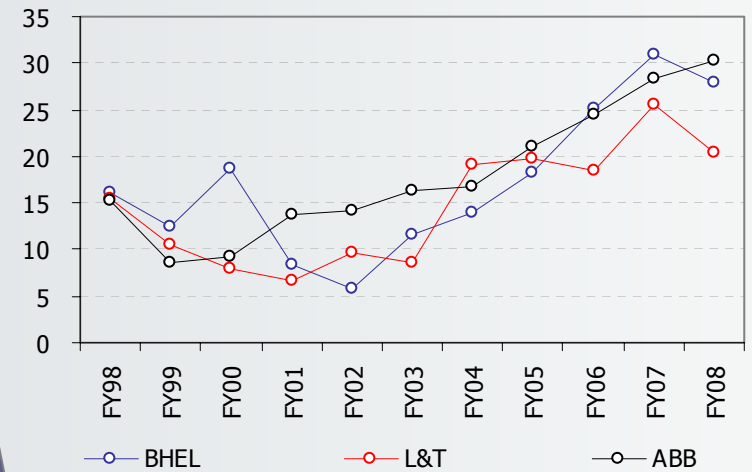
### Asset turns (x)



### OPM(%)



### RoE(%)



# Is it different vs. previous cycle?

- ➔ **Growth visibility of 15-25%**
  - Announced expansion plans of cement, metals, oil & gas are 50-100% of installed capacity
- ➔ **User industries (ex OMC) is less leveraged**
  - Leverage of large oil & gas (ex PSU Refiners), cement & metals cos. are at 0.5-1x vs. 1 - 3x in FY99
  - Capex = ~4-6 yrs of operating cash flows
  - However, PSU Oil Marketing Cos. (OMC) are unable to meet working capital requirement currently! (~1/3rd of planned oil capex)
- ➔ **Most Engg cos. are expanding capacity**
  - BHEL from 6,000MW to 20,000MW in FY12
  - Areva & ABB from 10,000MVA to ~30,000 MVA
- ➔ **India now key mkt for all large MNCs**
  - India forms 10-20% of global operations of MNC such as ABB, Areva, Siemens, etc
  - Chinese equipment mfrs are gaining ground
- ➔ **Execution challenges**
  - Rising talent cost, while order book-to-sales at 3-4x in FY08 vs. ~1-2x in FY98

## User industry is less leveraged

FY08 (Rs bn)	Net worth	Net Debt	Cash Profit	Capex FY08-12
Oil & Gas	2,386	906	707	4,118
Metals	1,267	449	348	1,187
Cement	344	119	114	433

## A comparison with previous cycle

(Rs mn)	FY98	FY01	FY08
<b>BHEL</b>			
Sales	51,410	59,459	193,655
OPM (%)	14.3	11.0	19.6
PAT	4,156	3,044	27,386
Debt:Equity (x)	0.2x	0.3x	0.0x
Order book / Sales (x)	1.9x	1.7x	4.4x
RoCE (%)	29	13	47
<b>L&amp;T</b>			
Sales	56,768	73,791	291,969
OPM (%)	12.3	13.2	12.9
PAT	4,213	2,621	21,878
Debt:Equity (x)	0.8x	1.1x	0.1x
Order book / Sales (x)	1.0x	1.3x	1.8x
RoCE (%)	14	10	19
<b>ABB</b>			
Sales	8,692	7,933	59,303
OPM (%)	8.3	11.8	13.1
PAT	384	535	4,917
Debt:Equity (x)	0.0x	0.0x	0.0x
Order book / Sales (x)	-	0.9x	0.8x
RoCE (%)	19	19	54

Source :Company, ENAM Research

**Sustainable RoE's would be higher than previous cycle**

# Is the expected slowdown in the price?

Company	M.Cap (Rs bn)	PE (x) 1 yr fwd	Tgt PE (x) FY11E	Reqd EPS 50% upside	CAGR FY08-11E 100% upside	Likely / Unlikely	Comments
L&T *	682	22	16	43	57	Unlikely	Expect L&T to continue to grow @ 20% CAGR over FY08-12 with a sustainable RoE of 20% vs. avg of 18% over FY00-08
BHEL	848	25	18	37	51	Unlikely	Mgmt.'s guidance of Rs 450bn of revenues by FY12 and sustaining FY08 profitability, implies a 20% CAGR over FY08-12. Expect sustainable RoE of 22% vs. avg of 20% over FY99-08
Suzlon	340	24	18	35	49	Unlikely	Suzlon to outpace mkt growth of 25% till 2010; to grow in-line with mkt beyond 2010; However profitability and RoE's could improve from 17% to 20%+ as capex is close to completion
ABB	185	29	18	46	61	Unlikely	Mgmt.'s guidance of topline CAGR of 25% over CY08-10 ; we believe profitability to be marginally lower compared to CY07 levels. Expect sustainable RoE of 23% vs. avg of 21% over CY00-07
Siemens	185	23	16	48	63	Unlikely	Mgmt.'s guidance of topline CAGR of 25% over 3 years ; profitability is likely to improve as proportion of trading & projects declines. Expect sustainable RoE of 23% vs. avg of 26% over CY00-07 due to declining contribution from high RoE I.T business
Crompton Greaves	94	18	13	41	55	Unlikely	Mgmt.'s guidance of 20-25% CAGR over next 3 years and improvement in EBIT margins from 12% to 14%. Expect sustainable RoE of 21% vs. avg of 20% over FY02-08
Bharat Electronics	75	9	10	11	22	50% L / 100% UL	Mgmt.'s guidance of Rs 80bn of revenues by FY12, implies a 18% CAGR over FY09-12; However we believe margins are likely to contract as pvt players enter defense sector. Expect sustainable RoE of 20% vs. avg of 30% over FY00-08
Thermax	58	19	14	29	42	Unlikely	Expect 25% topline CAGR over FY8-11; Profitability likely to decline as it enters highly competitive utility boilers businesses. Expect sustainable RoE of 21% vs. avg of 20% over FY02-08
Cummins	62	16	14	28	41	Unlikely	Mgmt.'s guidance of ~20% CAGR over medium term; we believe profitability would improve from FY08 levels. Expect sustainable RoE of 23% vs. avg of 20% over FY00-08
AIA Engineering	30	16	15	37	50	Unlikely	Mgmt.'s guidance of Rs 15bn of revenues by FY11 and sustainable NPM of 16% implies a 22% CAGR over FY08-11. Expect sustainable RoE of 22% vs. avg of 34% over FY04-08

\* Adj for VoI of Rs 248

# Finding cyclical trough prices: Methodology

## ⇒ P/E and sustainable RoE

- Historically, engineering stocks have traded in a 1yr fwd PER band of 0.6-1x RoE given the strong growth and free cash generation in the past four years
- Valued engineering companies at FY09E PE of 0.5 – 0.9x LT sustainable RoE based on resilience of their business models

## ⇒ P/B and cost of Equity

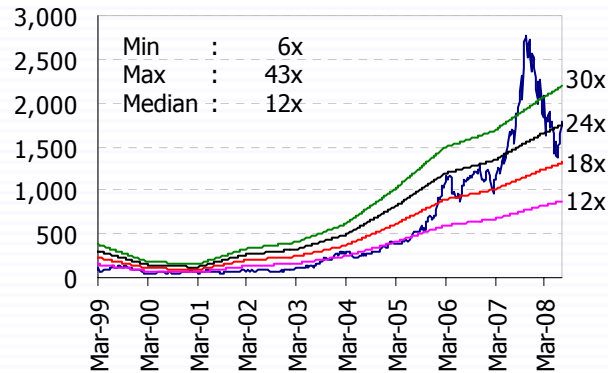
- P/B is a stable metric as it rewards companies that use capital effectively
- Engineering being asset light business generates high RoE in an up-cycle. Hence, we have considered LT sustainable growth, cost of equity and sustainable RoE and valued companies at 2-4x FY09E book
  - ▶ **Target P/B = (ROE-LT growth) / (Cost of Equity - LT growth)**

## ⇒ EV/Backlog

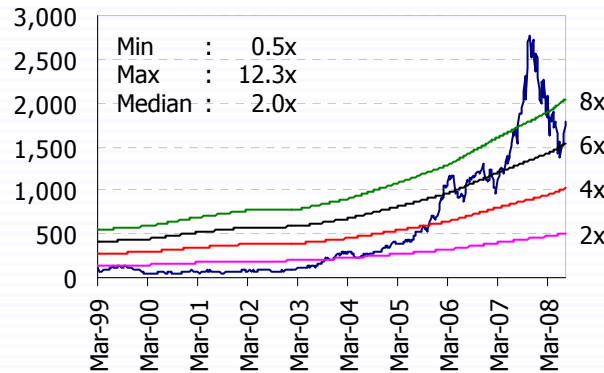
- Captures visibility for near-to-medium term revenue growth
- Valued engineering companies at 0.5 – 1.5x FY08 backlog depending on the average age of execution and proportion of variable contracts



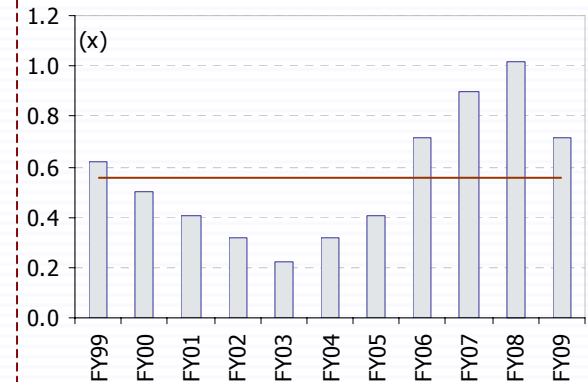
## P/E Band



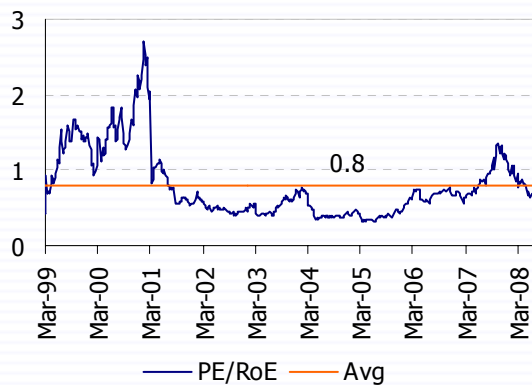
## P/B Bands



## EV/Backlog

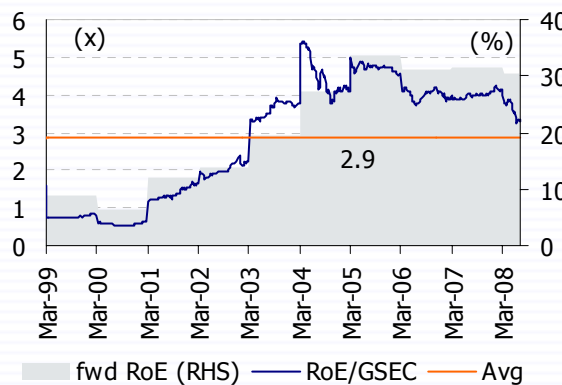


## PE/RoE



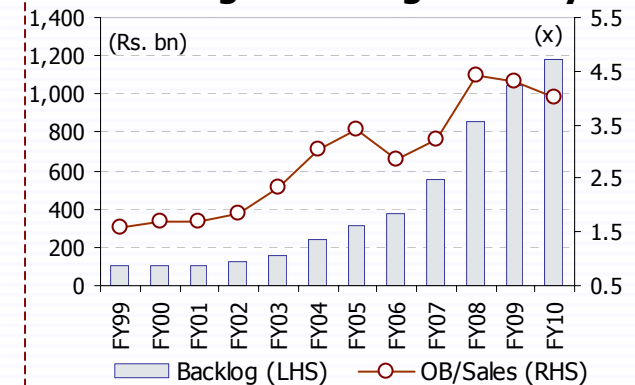
Sustainable RoE = 22%  
 Target PE = 18X  
 Target = 1,242

## RoE/GSec



LT growth = 11.5%  
 Cost of Equity = 14.6%  
 Target P/B = 3.4x  
 Target = 801

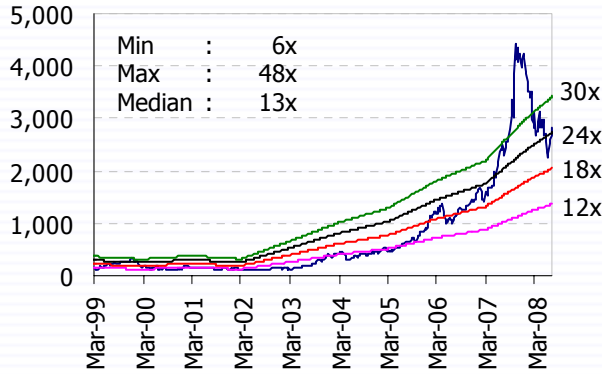
## Backlog & Backlog Visibility



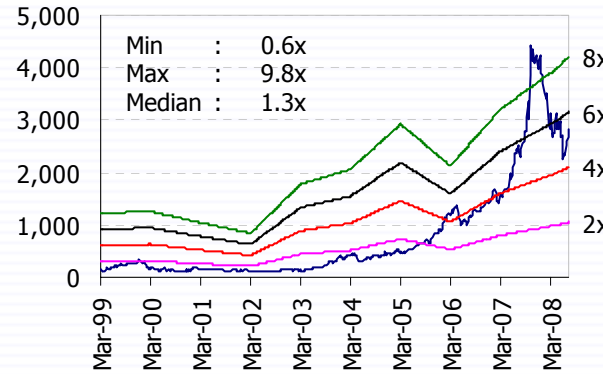
FY08 Backlog = 854bn  
 Target EV/OB = 0.6x  
 Target = 1,203

**Average : Rs 1,082**

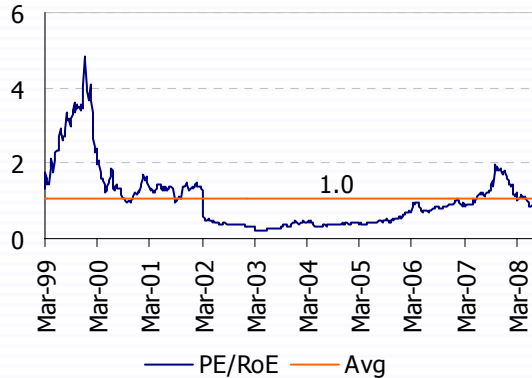
### P/E Band



### P/B Bands



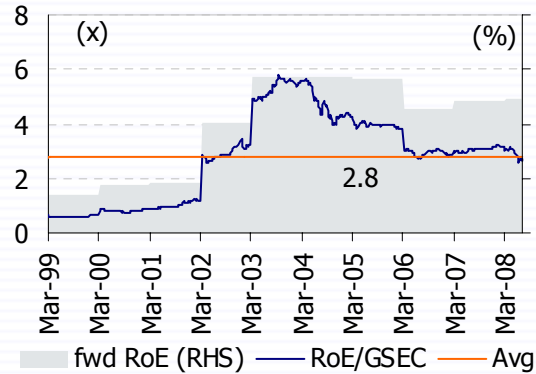
### PE/RoE



Sustainable RoE = 20%  
 Target PE = 16x  
 Target (inc. VoI#) = 1,924

# VoI = Value of Investments  
 Rs 248

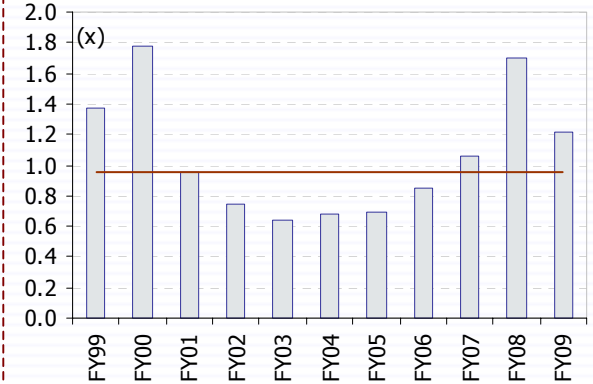
### RoE/GSec



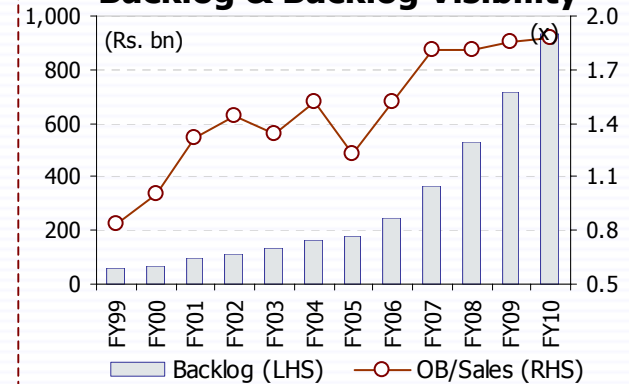
LT growth = 12%  
 Cost of Equity = 14.6%  
 Target P/B = 3.1x  
 Target (incl. VoI) = 1,746

**Average : Rs 1,712**

### EV/Backlog

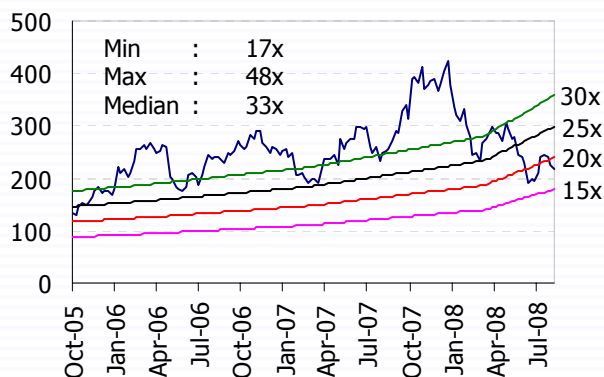


### Backlog & Backlog Visibility

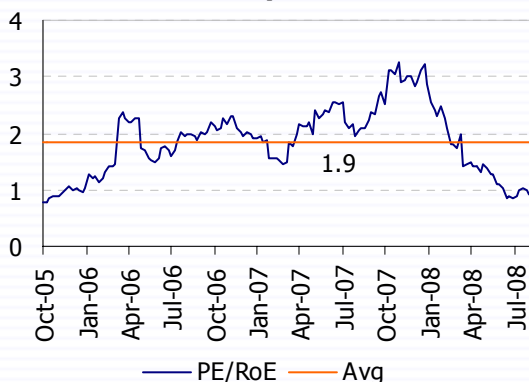


FY08 Backlog = 526bn  
 Target EV/OB = 0.8x  
 Target (incl. VoI) = 1,468

## P/E Band

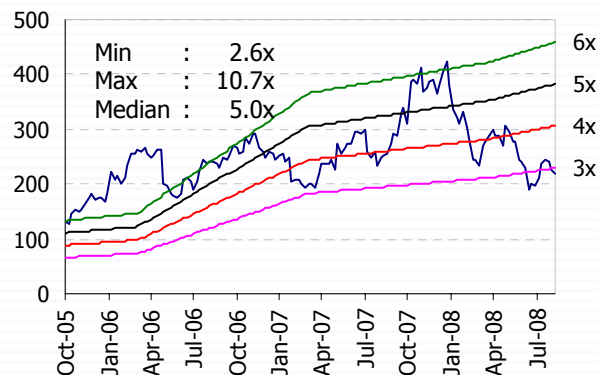


## PE/RoE

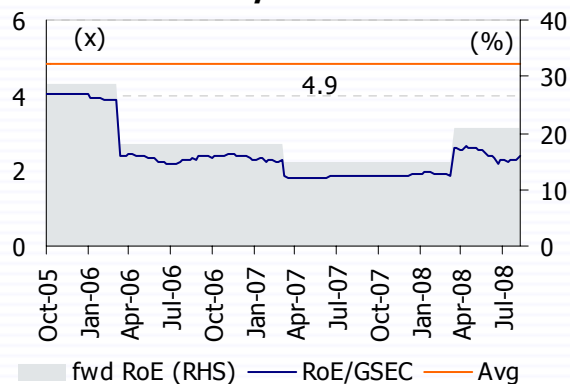


Sustainable RoE = 22%  
 Target PE = 18x  
 Target = 167

## P/B Bands



## RoE/GSec



LT growth = 13%  
 Cost of Equity = 15.8%  
 Target P/B = 3.2x  
 Target = 225

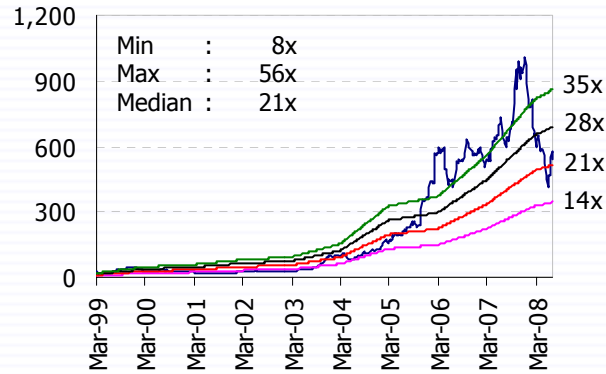
## Int. Peer Comparison\*

	Nordex	Gamesa	Vestas	Suzlon
M. Cap (\$ bn)	2.2	10.3	21.5	7.7
<b>CAGR (%)</b>				
Sales	51	18	26	34
PAT	25	31	54	45
<b>RoE (%)</b>				
CY08E	18	21	27	15
CY09E	20	21	28	21
<b>PER (x)</b>				
CY08E	31	26	32	24
CY09E	21	20	23	14
<b>EV/EBITDA (x)</b>				
CY08E	15	13	17	18
CY09E	10	11	13	12

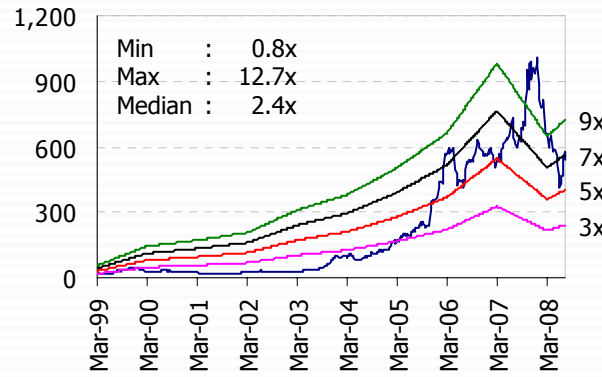
**Average : Rs 196**

\* Not considered for valuation, presented for comparison

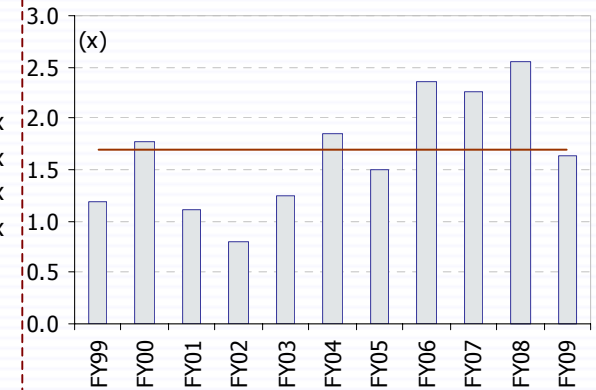
## P/E Band



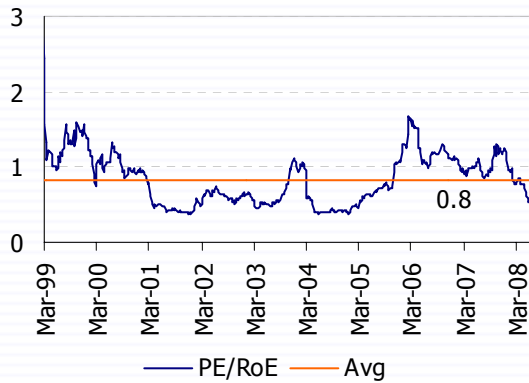
## P/B Bands



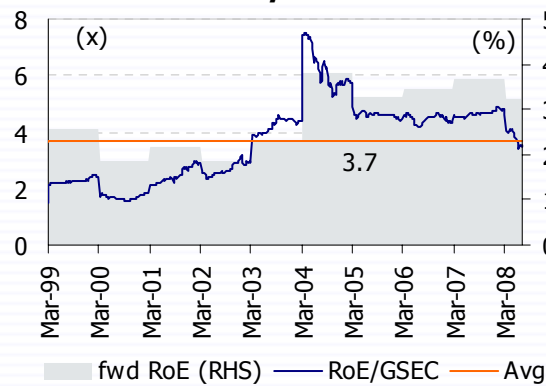
## EV/Backlog



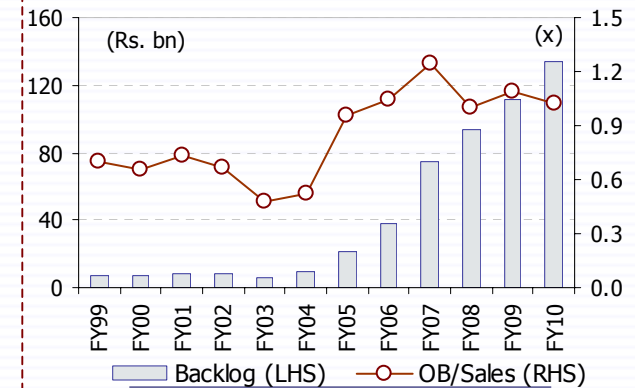
## PE/RoE



## RoE/GSec



## Backlog & Backlog Visibility



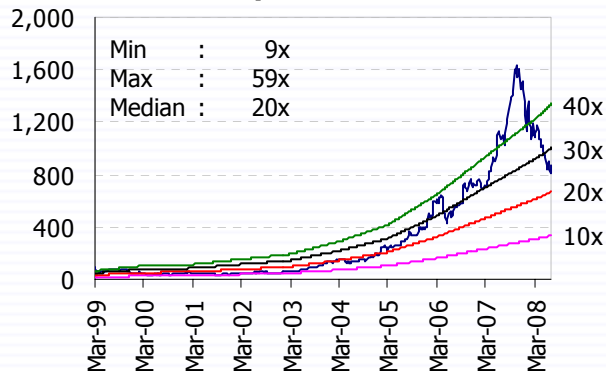
Sustainable RoE = 23%  
 Target PE = 16x  
 Target = 431

LT growth = 11%  
 Cost of Equity = 13.9%  
 Target P/B = 4.1x  
 Target = 391

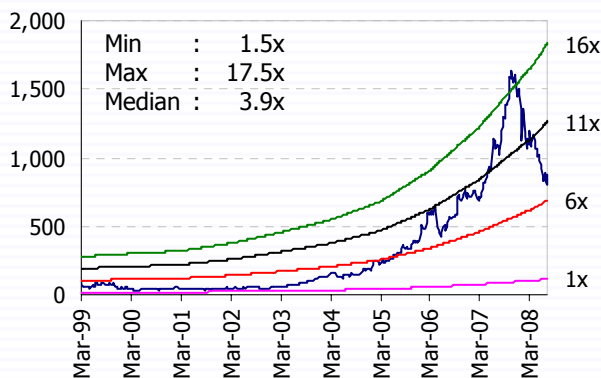
Current Backlog = 985bn  
 Target EV/OB = 1.3x  
 Target = 385

**Average : Rs 402**

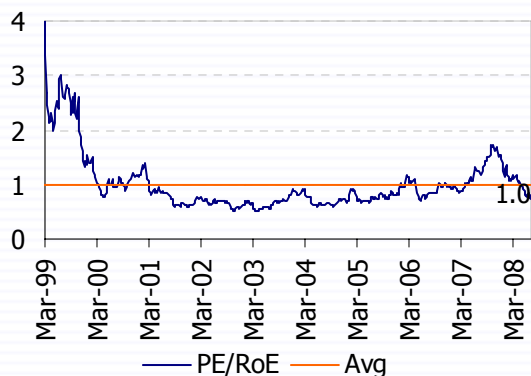
## P/E Band



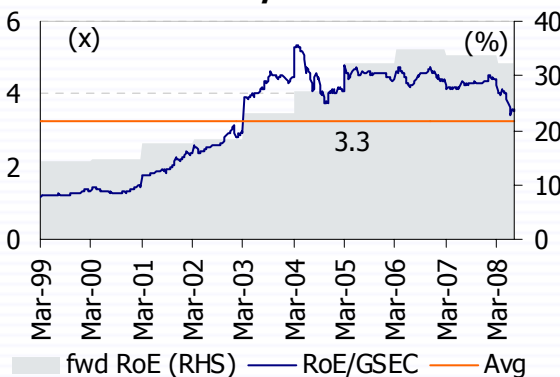
## P/B Bands



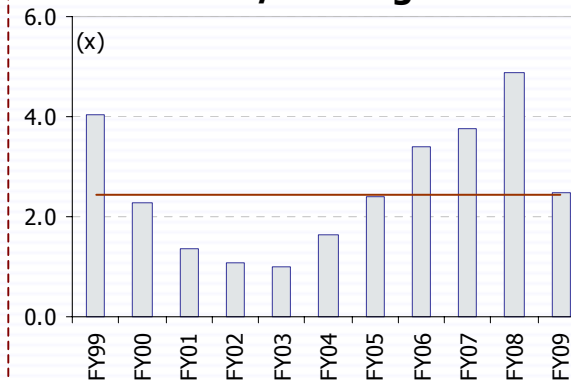
## PE/RoE



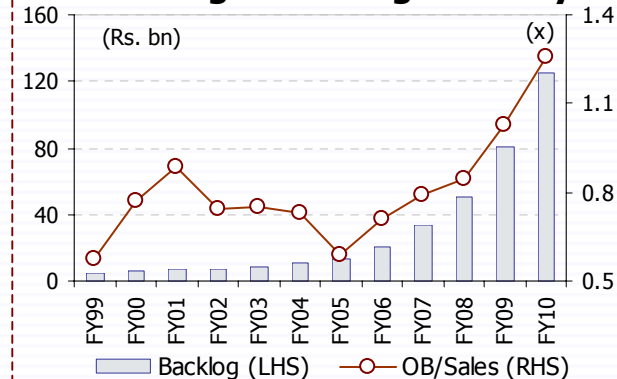
## RoE/GSec



## EV/Backlog



## Backlog & Backlog Visibility



Sustainable RoE = 23%  
 Target PE = 18x  
 Target = 546

LT growth = 11.5%  
 Cost of Equity = 13.9%  
 Target P/B = 4.1x  
 Target = 425

Current Backlog = 80bn  
 Target EV/OB = 1.5x  
 Target = 505

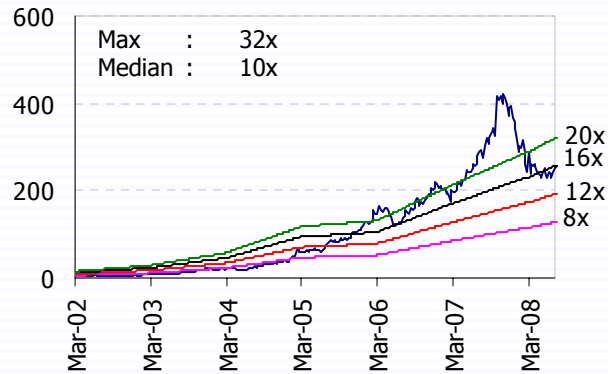
**Average : Rs 492**

# Crompton Greaves

**CMP** : Rs 256  
**Target Price** : Rs 300  
**52-wk Low** : Rs 195



**P/E Band\***

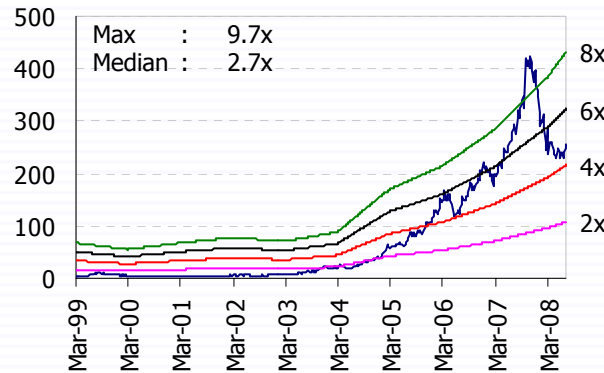


**PE/RoE\***

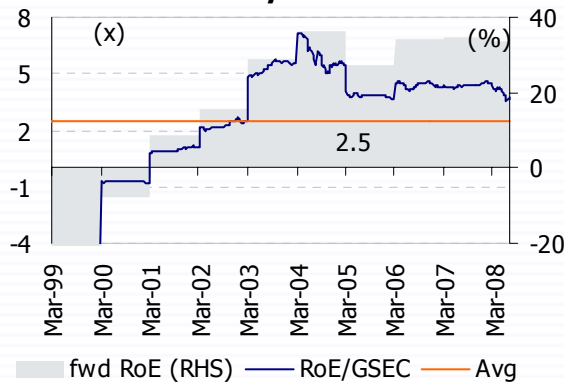


Sustainable RoE = 21%  
 Target PE = 13x  
 Target = 187

**P/B Bands**

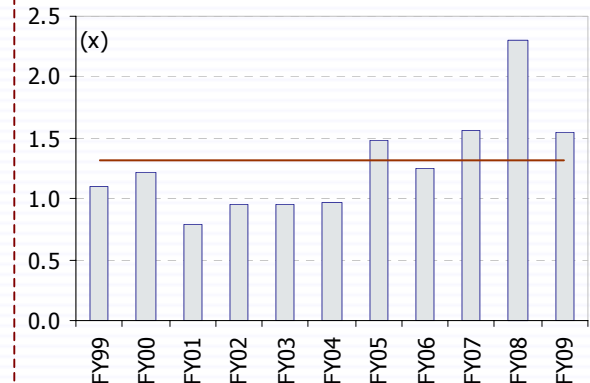


**RoE/GSec**

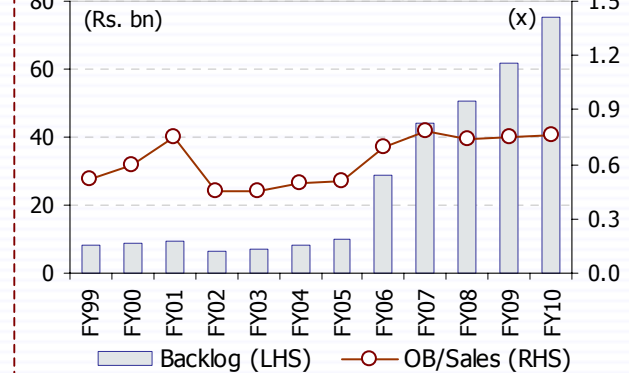


LT growth = 10%  
 Cost of Equity = 14%  
 Target P/B = 3.3x  
 Target = 160

**EV/Backlog**



**Backlog & Backlog Visibility**

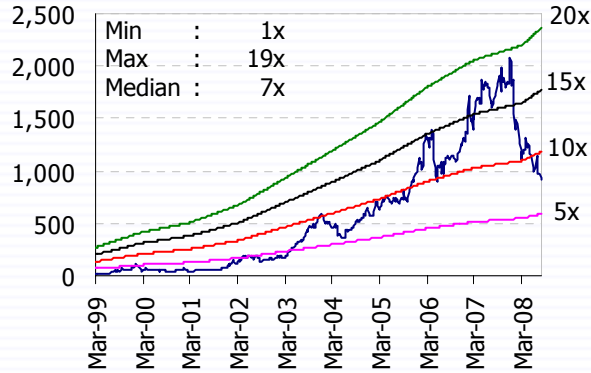


Current Backlog = 60bn  
 Target EV/OB = 1.2x  
 Target = 180

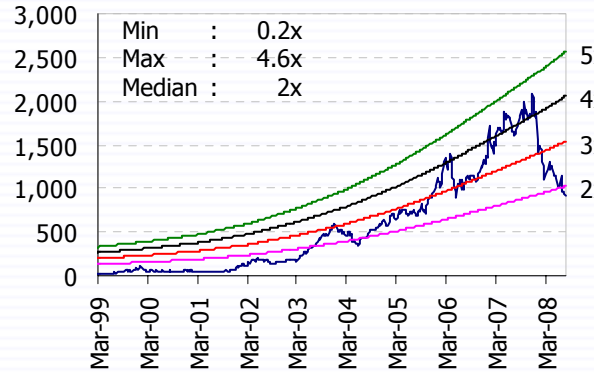
**Average : Rs 176**

\* Due to losses in FY01, we have considered data only from FY02

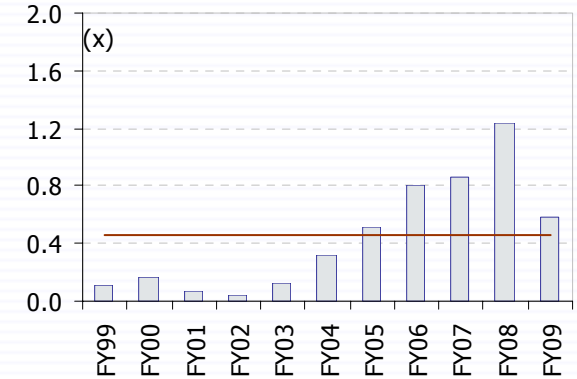
### P/E Band



### P/B Bands



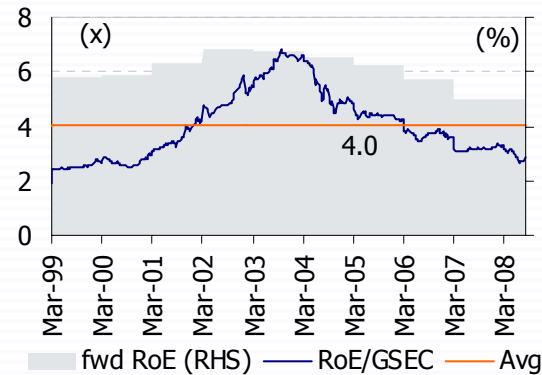
### EV/Backlog



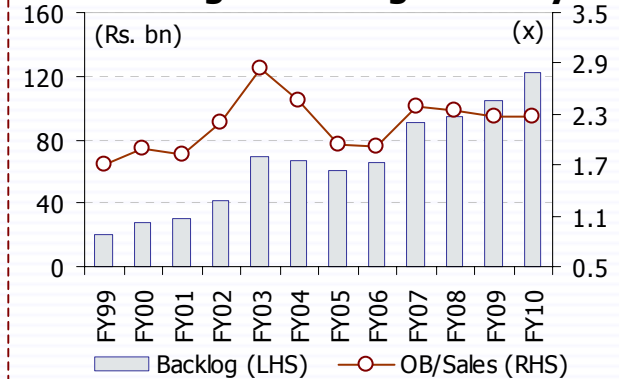
### PE/RoE



### RoE/GSec



### Backlog & Backlog Visibility



Sustainable RoE = 20%  
 Target PE = 10x  
 Target = 1,097

LT growth = 7%  
 Cost of Equity = 14%  
 Target P/B = 2x  
 Target = 883

FY08 Backlog = 95bn  
 Target EV/OB = 0.5x  
 Target = 840

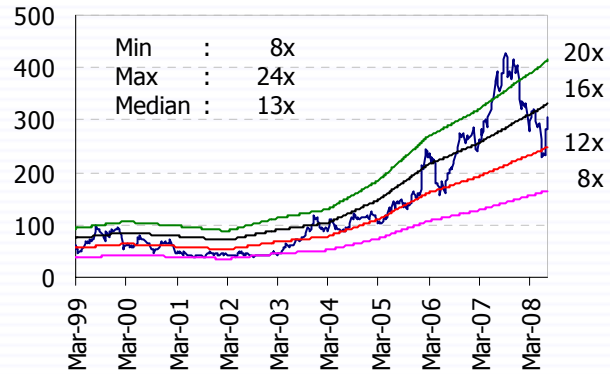
**Average : Rs 940**

# Cummins India

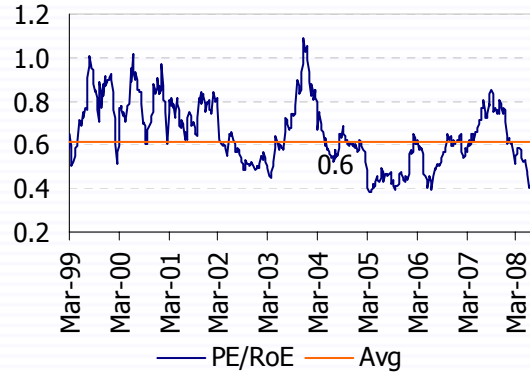
**CMP** : Rs 315  
**Target Price** : Rs 340  
**52-wk Low** : Rs 225



### P/E Band

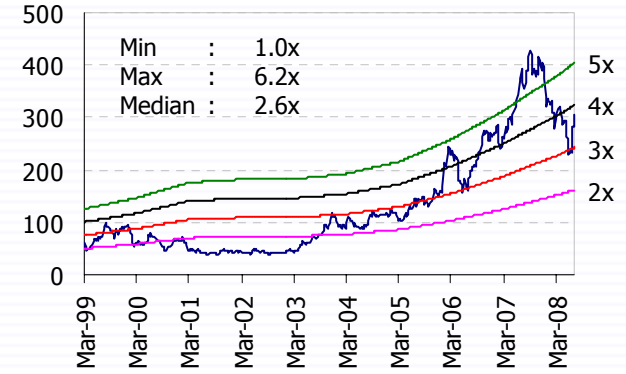


### PE/RoE

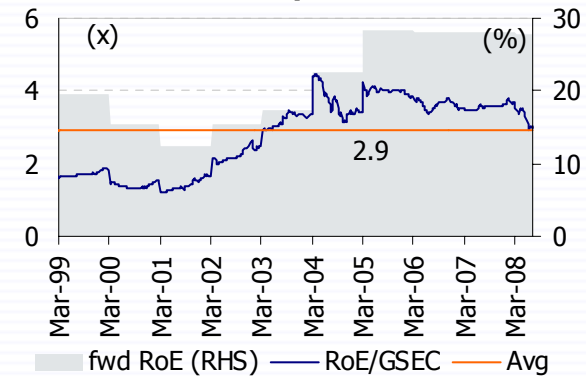


Sustainable RoE = 23%  
 Target PE = 14x  
 Target = 272

### P/B Bands



### RoE/GSec

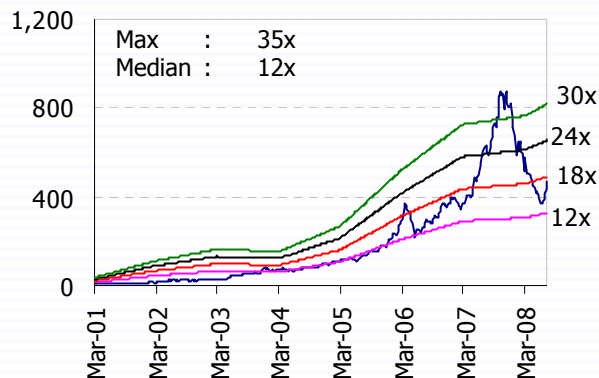


LT growth = 9%  
 Cost of Equity = 13.4%  
 Target P/B = 3.2x  
 Target = 240

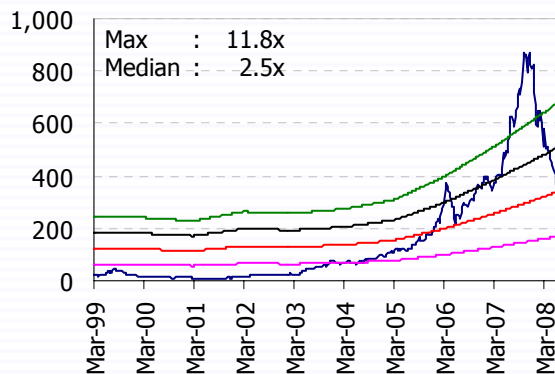
**Average : Rs 256**



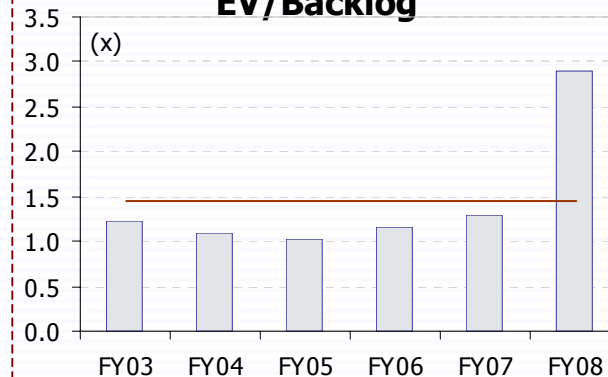
### P/E Band\*



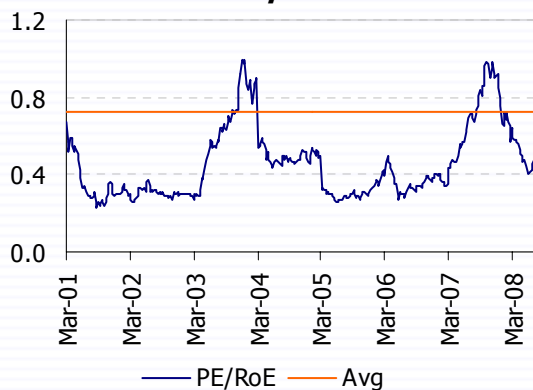
### P/B Bands



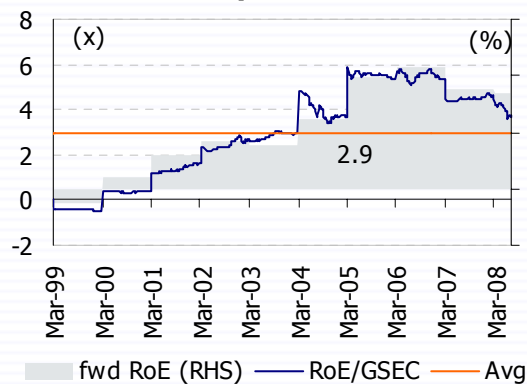
### EV/Backlog



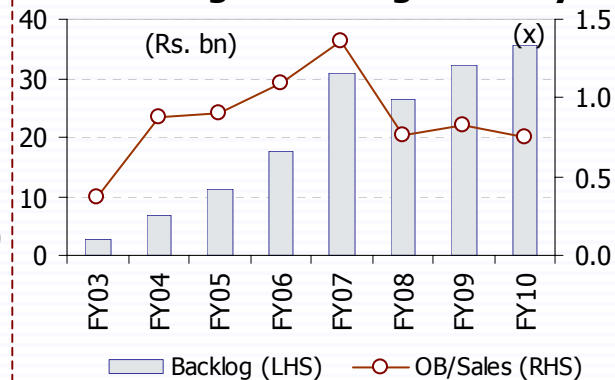
### PE/RoE\*



### RoE/GSec



### Backlog & Backlog Visibility



Sustainable RoE = 22%  
 Target PE = 14x  
 Target = 357

LT growth = 10%  
 Cost of Equity = 14%  
 Target P/B = 3.3x  
 Target = 260

Current Backlog = 28bn  
 Target EV/OB = 1.4x  
 Target = 385

**Average : Rs 334**

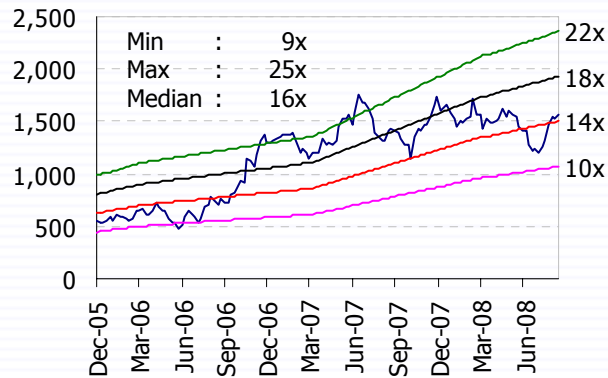
\* Due to losses in earlier years, we have considered data only from FY01

# AIA Engineering

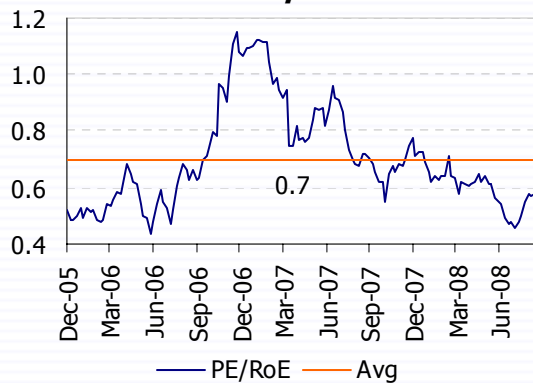
**CMP** : Rs 1,571  
**Target Price** : Rs 1,500  
**52-wk Low** : Rs 1,044



### P/E Band

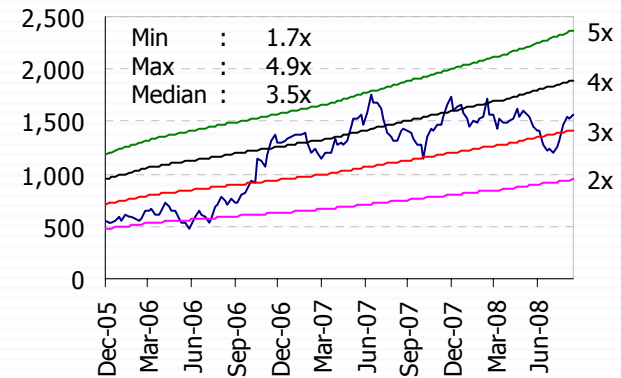


### PE/RoE

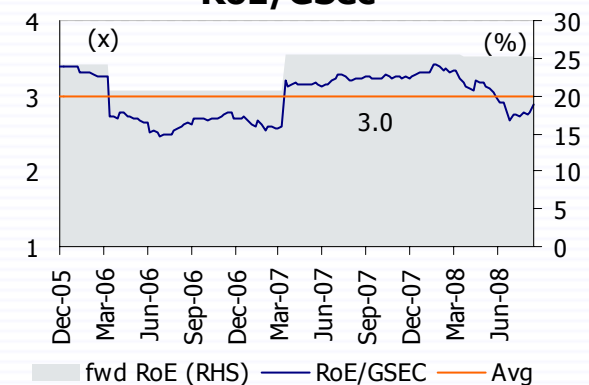


Sustainable RoE = 22%  
 Target PE = 15x  
 Target = 1,452

### P/B Bands



### RoE/GSec



LT growth = 9%  
 Cost of Equity = 13.4%  
 Target P/B = 3x  
 Target = 1,254

**Average : Rs 1,353**

# Global peer group valuations

	M Cap USD bn	Ratio Analysis (%)			Gwth - 2yrs		Valuations (x)					
		OPM	PAT Margin	RoE	Sales	PAT	P/E		EV/EBITDA		MCAP/Sales	
							CY08E/ FY09E	CY09E/ FY10E	CY08E/ FY09E	CY09E/ FY10E	CY08E/ FY09E	CY09E/ FY10E
<b>Developed Markets</b>												
General Electric	277	21.1	13.1	20	9	1	12.6	11.9	19.2	18.0	1.5	1.4
Siemens AG	91	11.6	5.3	14	9	28	15.7	10.6	8.2	6.6	0.8	0.8
ABB Ltd	52	15.8	12.9	44	16	8	12.9	11.6	7.3	6.6	1.5	1.3
Schneider Electric	23	17.8	9.1	17	7	8	8.9	8.9	0.0	0.0	0.9	0.9
<b>Average</b>					<b>11</b>	<b>11</b>	<b>12.5</b>	<b>10.3</b>	<b>5.2</b>	<b>4.4</b>	<b>1.1</b>	<b>1.0</b>
<b>Emerging Mkts</b>												
Shanghai Electric	5	8.8	5.0	15	20	10	11.6	11.3	5.3	5.1	0.5	0.5
Dongfang Electric	3	12.5	9.2	62	15	-1	19.9	8.5	6.6	4.4	0.8	0.7
Harbin Power Equip.	1	9.4	5.5	25	12	-1	6.8	6.9	2.8	2.8	0.3	0.3
Doosan Heavy	8	9.3	7.3	13	16	26	25.5	15.5	20.1	15.7	1.7	1.4
Toshiba Corp	16	8.1	1.7	12	6	5	15.5	13.2	5.5	4.7	0.2	0.2
<b>Average</b>					<b>11</b>	<b>8</b>	<b>15.9</b>	<b>11.1</b>	<b>8.1</b>	<b>6.6</b>	<b>0.7</b>	<b>0.6</b>
<b>Indian Companies</b>												
BHEL	19	19.6	14.1	31	24	20	25.1	21.5	16.4	13.7	3.5	2.9
L&T	17	12.9	7.5	23	30	33	25.0	20.1	16.3	13.3	2.0	1.5
ABB India	4	13.1	8.3	35	30	29	28.8	22.5	17.5	13.4	2.4	1.9
Siemens India	4	9.2	5.7	35	18	30	23.5	20.3	14.0	11.4	1.8	1.4
Crompton Greaves	2	11.5	5.7	34	20	33	17.8	13.5	10.3	8.0	1.1	0.9
Areva T&D India	2	18.3	10.8	47	31	26	29.9	22.8	17.5	13.6	3.0	2.3
Cummins	1	16.8	11.9	28	20	20	16.2	13.7	11.1	9.2	1.9	1.6
Thermax	1	12.7	8.4	43	18	12	19.1	15.9	11.5	9.5	1.5	1.2
<b>Average</b>					<b>24</b>	<b>26</b>	<b>23.2</b>	<b>18.8</b>	<b>14.3</b>	<b>11.5</b>	<b>2.2</b>	<b>1.7</b>

Source: Bloomberg, Company, ENAM Research

**Indian stocks trade at a premium to global peers due to superior growth and return ratios**

# ENAM Securities Pvt. Ltd.

7, Tulsiani Chambers, Free Press Journal Marg, Nariman Point, Mumbai – 400 021, India..

**Tel:- Board +91-22 6754 7600; Dealing +91-22 2280 0167;**

**Fax:- Research +91-22 6754 7679; Dealing +91-22 6754 7575**

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	<b>BHEL</b>	<b>L&amp;T</b>	<b>Suzlon</b>	<b>ABB</b>	<b>Siemens</b>	<b>Cormpton</b>	<b>Cummins</b>	<b>Thermax</b>	<b>AIA Engg.</b>	<b>BEL</b>
1. Analyst ownership of the stock	No	Yes	No	No	No	No	No	No	Yes	No
2. Firm ownership of the stock	No	No	No	No	No	No	No	No	No	No
3. Directors ownership of the stock	No	Yes	Yes	No	No	No	No	No	No	No
4. Investment Banking mandate	No	No	No	No	No	No	No	No	No	No
5. Broking relationship	No	No	No	No	No	No	No	No	No	No

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