

6 September 2010

Hero Honda Motors

Split or no split, attractively positioned

Buy

Target price
Rs2116.00

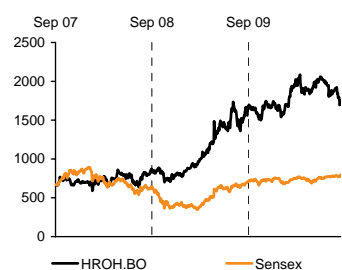
Price
Rs1703.30

Short term (0-60 days)
n/a

Market view
Underweight

Price performance

	(1M)	(3M)	(12M)
Price (Rs)	1834	1996	1611
Absolute (%)	-7.1	-14.7	5.7
Rel market (%)	-9.2	-21.3	-10.6
Rel sector (%)	-8.4	-20.4	3.5



Market capitalisation
Rs340.13bn (US\$7.32bn)

Average (12M) daily turnover
Rs930.99m (US\$20.27m)

Sector: BBG AP Autos
RIC: HROH.BO, HH IN
Priced Rs1703.30 at close 6 Sep 2010.
Source: Bloomberg

Researched by

RBS Equities (India) Limited
Institutional Team

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www.rbs.in/broking

JV split speculation has led to a sharp stock price decline. Although we consider the probability of a split low, given written denial by both parties, at the current attractive valuation of 14x FY11F EPS, the risks appear over-played as a split may result in royalty cost savings short term, export potential medium term.

Key forecasts

	FY09A	FY10A	FY11F	FY12F	FY13F
Revenue (Rsm)	123,192	158,605	193,274	214,905	234,226
EBITDA (Rsm)	17,098	27,670	29,536	33,193	35,375
Reported net profit (Rsm)	12,818	22,318	24,737	28,523	30,980
Normalised net profit (Rsm) ¹	12,818	22,318	24,737	28,523	30,980
Normalised EPS (Rs)	64.20	111.8	123.9	142.8	155.1
Dividend per share (Rs)	20.00	110.0	34.00	42.00	46.00
Dividend yield (%)	1.17	6.46	2.00	2.47	2.70
Normalised PE (x)	26.50	15.20	13.80	11.90	11.00
EV/EBITDA (x)	17.80	11.20	10.00	8.31	7.25
Price/book value (x)	8.95	9.82	6.61	4.84	3.76
ROIC (%)	201.6	466.3	327.5	296.2	337.2

1. Post-goodwill amortisation and pre-exceptional items
Accounting standard: Local GAAP
Source: Company data, RBS forecasts
year to Mar, fully diluted

A split may be financially positive in the short term for Hero Honda

In FY10, Hero Honda awarded 2.7% of net sales as royalty payments to Honda Japan, a figure that has increased gradually from 2.1% in FY05. If the JV between these two were to end, royalty payments would be reduced sharply from current levels, although Hero Honda may be forced to spend more on research and development, which account for around 1.5-2.0% of net sales for Indian competitors Bajaj and TVS on average. Also, considering that all of its products comply with new emission norms and R&D expenses qualify for 150% tax deduction, the risk to profitability in the short term is low, in the event of a split.

How big is technology hurdle for Hero Honda in the medium term if a split occurs?

We believe sustaining the degree of technological superiority extended by Honda will be difficult for HH, especially in engine technology. However, we believe its existing portfolio is strong, supported by strong distribution throughout the country. HH's initial R&D capability should be sufficient to carry out cosmetic changes to the product, which should aid in meeting rapidly changing customer tastes. For the long term, expansion in HH's addressable market to cover large export markets provides additional scope for volume growth.

Worst split fears appear priced in; we rate the stock a Buy either way

Our channel checks with vendors and dealers rule out any immediate risk of a split. However, the threat of Honda competition and a possible JV split has been hovering over HH since CY09, when HMSI announced plans to enter the 100cc motorcycle segment. We believe the share price already reflects a high chance of a JV split (16x 1-year forward PE in June 10 vs 13x now) against Sensex (flat 16x). Even though a last leg of correction may occur with an actual announcement, we believe HH remains a Buy, considering potential short- and medium-term benefits of a split, and, in our view, the risk-reward is favourable at the current PERs of 14x FY11F and 12.2x FY12F. We believe expansion of the addressable market would help deploy capital towards higher ROCE core automobile business, compared with low-yielding cash sitting on the books currently.

Important disclosures can be found in the Disclosures Appendix.

Analysis of JV split scenario

We believe the recent stock correction, over concerns about sustainability of technological superiority, is overdone. The attractive valuation of 14x FY11F pre-split, or potential benefits of royalty cost savings and export markets post-split, outweigh the negatives.

Not the first time this speculation has happened, but why the 'now or never' scenario?

Hero Honda, a joint venture between Hero Group and Honda of Japan with each holding a 26% financial stake, has long-term agreements regarding technology and cooperation on new products. The most recent one is valid until mid-2014. Speculation of a split between Hero and Honda has increased sharply of late, as the expiry date of the technology agreement approaches. Despite official written denial by both Honda Japan and Hero Group, we note the following developments that may be behind the latest split speculation:

- Hero Group has restructured family member holdings in Hero Honda so that the entire stake is now held by Brij Mohan Munjal. Other family members were compensated in this process.
- Honda Motorcycle and Scooters India (HMSI) entered the 100cc motorcycle market in CY10, and it is now eager to build scale in motorcycles after successfully establishing leadership in the scooter market.
- According to *The Economic Times*, delays in Hero Honda setting up a new plant are speculated to be due to pending permission from Honda for the capex programme. This will hurt Hero Honda sales volume growth, as it is already running at near full capacity, leading to long customer-waiting periods.

Split denied by both parties in official written communication

Both parties have officially denied the speculation in written communications to the market.

'Hero Group Says Report on Stake Sale 'Incorrect and Speculative' – "India's Hero group said the report on Japan's Honda Motor Co. selling its stake in the nation's largest motorcycle maker is "incorrect and speculative." – Source: Bloomberg

'Honda Says It Has 'No Plan' to Sell Stake in Hero Honda' – "Honda Motor Co. has no plan to sell a stake in Hero Honda Motors Ltd., Yuki Watanabe, a spokeswoman for the Japanese company, said in a phone interview today." – Source: Bloomberg

Without a split in sight, Hero Honda management states in the annual report favourable rural markets and demographic profile – where it has nearly 2,000 touch points currently and intends to reach out to smaller villages (populations of fewer than 5,000 people).

HH's chairman has also highlighted an inflexion point in the Indian lower middle class, which will favour sustained demand for basic mobility through bikes and scooters. "I am convinced that this will be the decade where lower middle class households (earning between Rs0.2m to Rs0.5m a year) will become India's largest and most influential consuming class, more powerful than the middle-middle class, the upper middle class and the upper class. In fact, if the last decade belonged to the Great Indian Middle Class, this decade will belong to the Great Lower Middle Class Indian. Consumer companies that wish to succeed in this environment will have to make the lower middle Indian central to their design of products, processes and strategies," said Chairman Brij Mohan Munjal.

What if a split does occur?

Short-term benefits to Hero Honda

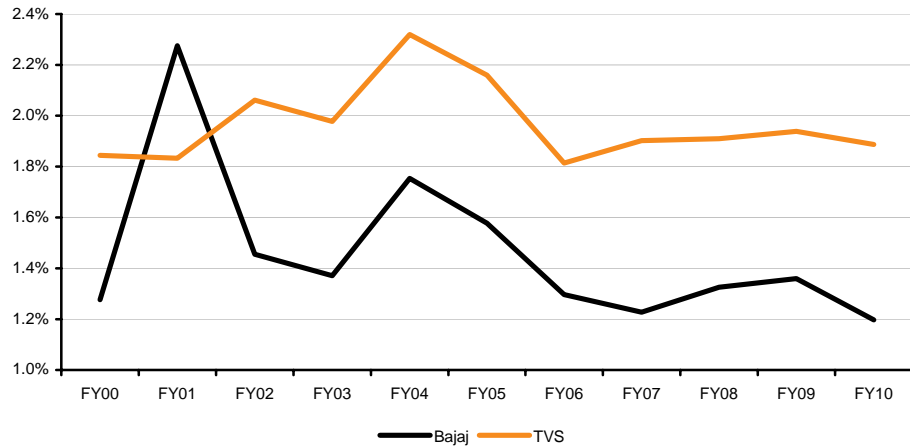
Financials: In the short term, we believe Hero Honda would be a net beneficiary of 1.2-1.7% of net sales if a split did occur, as the savings it would make on royalty payments would outweigh R&D expenses required in the segment, as explained next.

+ Saving in royalty payment of 2.7% of sales.

+ Saving in model development fees, which are part of capex and depreciation – ie 0.2% of net sales.

- R&D cost would come into play for Hero Honda in a much bigger way than the current level of 0.2% of net sales. R&D expenses for its smaller peers Bajaj and TVS in the last few years have averaged 1.5 and 2% of net sales, respectively. Considering the larger size of Hero Honda relative to peers, we believe 1.0% to 1.5% of net sales spent on R&D would be enough for Hero Honda to sustain its competitive edge in the Indian market.

Chart 1 : R&D expenses of peer domestic companies as a proportion of net sales



Note: R&D expenses include both capital and revenue expenditures.
Source: Company data

No major impact on new model plan in FY11F: Based on our recent channel checks with dealers, the company appears on course to launch and ramp up sales of new models Super Splendor 125cc, Splendor Pro – electric start, Karizma and Achiever.

Just crossed short-term technology hurdle: In the past six months, Hero Honda has upgraded all of its products to meet BS-III (Bharat Stage) emission norms, with the help of Honda Japan's R&D capability. We believe the next big leap in technology will be required only by 20014-15, when new norms come into effect based on government notification.

Medium-term concerns about technology support for Hero Honda

For the medium term, the market is concerned about the sustainability of technological superiority of Honda's engine technology by Hero Honda and its potential impact on sales volumes and profitability. In our view, even though it would be very difficult to replicate Honda's engine technology, the existing advantage over the competition in domestic two-wheelers should be possible with help of global engine design centres. Also, considering that only a fraction of Hero Honda sales is dependent upon new products, we believe the risk is relatively low.

However, the benefits in terms of speedy product refreshments/variants coming from an in-house design facility could give HH an edge, compared with the current process that requires getting approval from Honda Japan.

Similarly, a split could withdraw export limitations enforced in the JV agreement. This could open up large export opportunities in neighbouring Asian countries, Africa and Latin America – markets in which HH's 100cc motorcycles are appropriate, and where it would be well placed to leverage its global scale of operations.

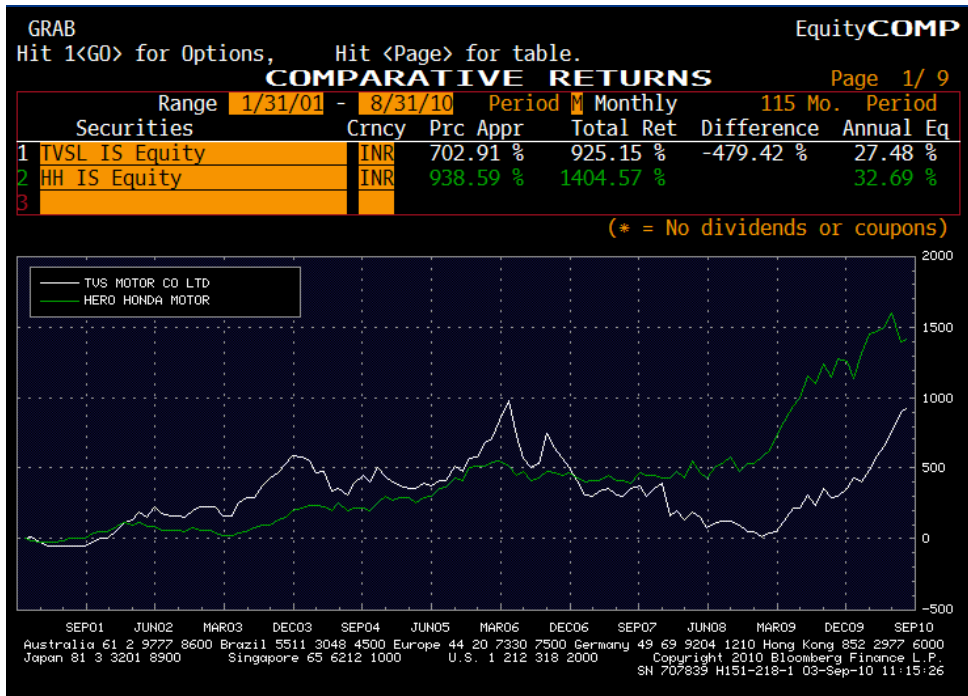
Valuation looks attractive; could Hero Honda repeat the stock pattern of TVS-Suzuki post split?

Assuming a no-split scenario, we believe Hero Honda is a well-positioned rural Indian play with a favourable valuation of 14x FY11F EPS, positive free cash flow and high sustainable ROE of 40%-plus. The improvement in the monsoon in recent weeks augurs well for the company, which plans to double distribution points in the next two years.

If the split did occur, we would be eager to see whether the stock follows the same pattern as TVS-Suzuki post split – where despite TVS's sharp market share slip in the medium term, the share price sharply outperformed the market after the group's September 2001 split from Suzuki.

Despite market share loss after split with Suzuki, TVS outperformed HH, which gained market share

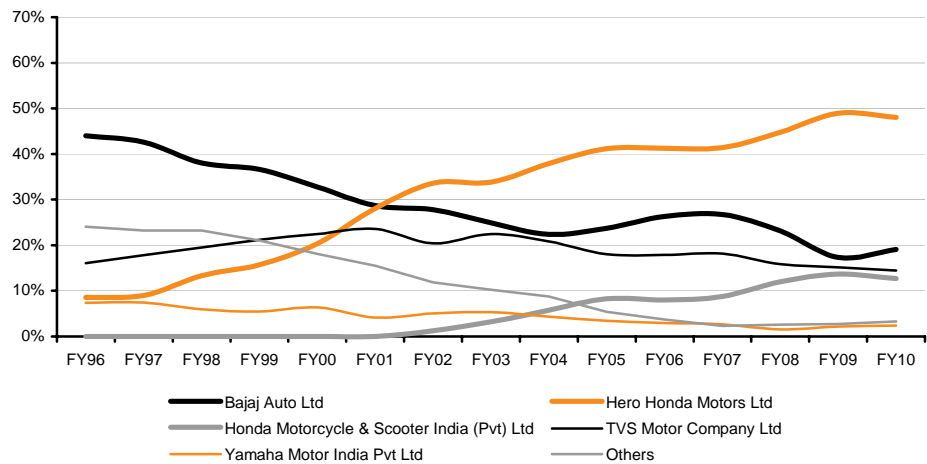
Chart 2 : Stock price performance of TVS vs Hero Honda



Source: Bloomberg

TVS market share slid from peak of FY01, post its JV split with Suzuki...

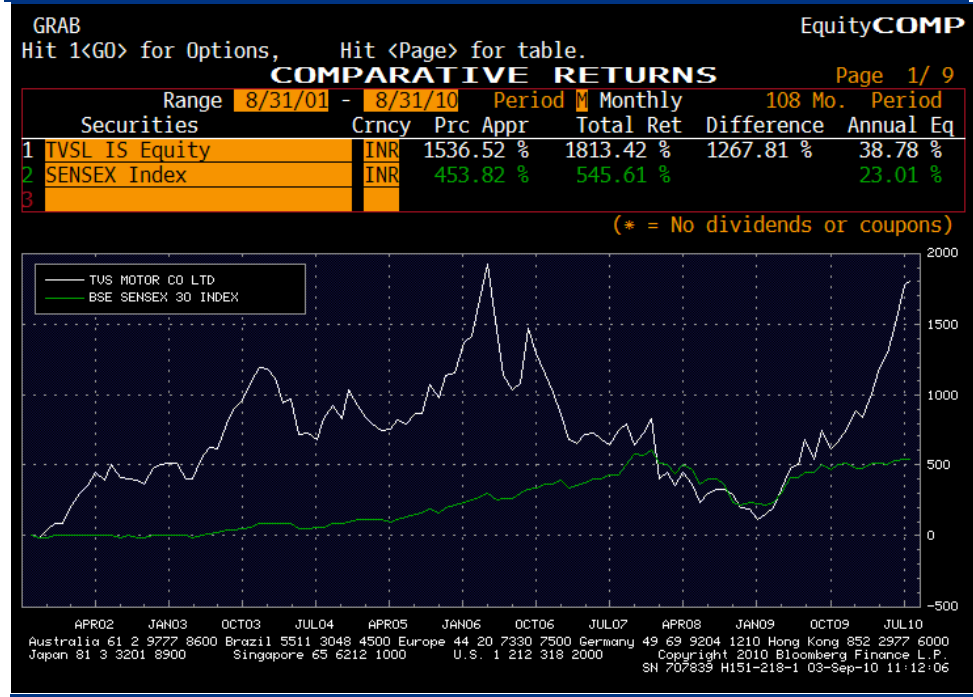
Chart 3 : Market share trend of two-wheelers



Source: SIAM

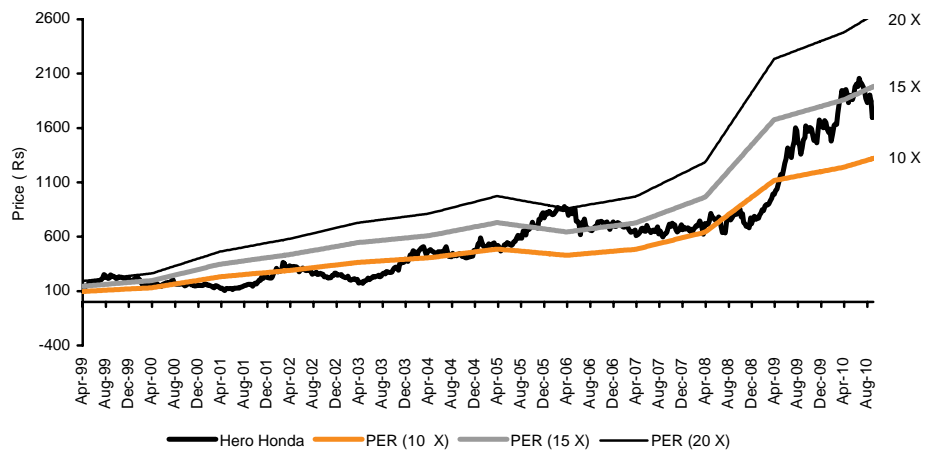
Chart 4 : Relative stock price performance of TVS vs Sensex

... yet, TVS sharply outperformed Sensex during Sept 2001 - Dec 2007



Source: Bloomberg

Chart 5 : Hero Honda forward PE band chart



Source: Bloomberg, RBS estimates

Income statement

Rsm	FY09A	FY10A	FY11F	FY12F	FY13F
Revenue	123192	158605	193274	214905	234226
Cost of sales	-91907	-112967	-140545	-156568	-170744
Operating costs	-14187	-17969	-23193	-25144	-28107
EBITDA	17098	27670	29536	33193	35375
DDA & Impairment (ex gw)	-1807	-1915	-2146	-2496	-2820
EBITA	15291	25755	27390	30697	32556
Goodwill (amort/impaird)	n/a	n/a	n/a	n/a	n/a
EBIT	15291	25755	27390	30697	32556
Net interest	2524	2563	3150	4300	5225
Associates (pre-tax)	n/a	n/a	n/a	n/a	n/a
Forex gain / (loss)	n/a	n/a	n/a	n/a	n/a
Exceptionals (pre-tax)	n/a	n/a	n/a	n/a	n/a
Other pre-tax items	0.00	0.00	0.00	0.00	0.00
Reported PTP	17815	28317	30540	34997	37781
Taxation	-4997	-5999	-5803	-6474	-6801
Minority interests	n/a	n/a	n/a	n/a	n/a
Exceptionals (post-tax)	n/a	n/a	n/a	n/a	n/a
Other post-tax items	0.00	0.00	0.00	0.00	0.00
Reported net profit	12818	22318	24737	28523	30980
Normalised Items Excl. GW	0.00	0.00	0.00	0.00	0.00
Normalised net profit	12818	22318	24737	28523	30980

Source: Company data, RBS forecasts

year to Mar

Balance sheet

Rsm	FY09A	FY10A	FY11F	FY12F	FY13F
Cash & market secs (1)	35883	30462	45763	65210	84709
Other current assets	7939	11452	14584	15161	17358
Tangible fixed assets	16943	18528	20381	21886	24066
Intang assets (incl gw)	n/a	n/a	n/a	n/a	n/a
Oth non-curr assets	0.00	0.00	0.00	0.00	n/m
Total assets	60765	60442	80729	102256	126133
Short term debt (2)	n/a	n/a	n/a	n/a	n/a
Trade & oth current liab	20528	23206	26520	29129	32548
Long term debt (3)	784.9	1000	1000	1000	1000
Oth non-current liab	1444	1586	1739	1914	2102
Total liabilities	22757	25792	29258	32043	35651
Total equity (incl min)	38008	34650	51470	70213	90482
Total liab & sh equity	60765	60442	80729	102256	126133
Net debt	-35098	-29462	-44763	-64210	-83709

Source: Company data, RBS forecasts

year ended Mar

Cash flow statement

Rsm	FY09A	FY10A	FY11F	FY12F	FY13F
EBITDA	17098	27670	29536	33193	35375
Change in working capital	847.3	218.1	-145.5	306.1	261.9
Net interest (pd) / rec	2524	2563	3150	4300	5225
Taxes paid	-4806	-5857	-5650	-6300	-6612
Other oper cash items	1551	-1053	326.5	1727	960.3
Cash flow from ops (1)	17214	23540	27217	33226	35211
Capex (2)	-3102	-3500	-4000	-4000	-5000
Disposals/(acquisitions)	0.00	0.00	0.00	0.00	0.00
Other investing cash flow	-8019	5000	-16000	-18000	-20000
Cash flow from invest (3)	-11121	1500	-20000	-22000	-25000
Incr / (decr) in equity	0.00	0.00	0.00	0.00	0.00
Incr / (decr) in debt	-535.1	215.1	0.00	0.00	0.00
Ordinary dividend paid	-4673	-25676	-7917	-9780	-10711
Preferred dividends (4)	n/a	n/a	n/a	n/a	n/a
Other financing cash flow	n/a	n/a	n/a	n/a	n/a
Cash flow from fin (5)	-5208	-25461	-7917	-9780	-10711
Forex & disc ops (6)	n/a	n/a	n/a	n/a	n/a
Inc/(decr) cash (1+3+5+6)	884.8	-420.7	-699.7	1447	-500.3
Equity FCF (1+2+4)	14112	20040	23217	29226	30211

Lines in bold can be derived from the immediately preceding lines.
Source: Company data, RBS forecasts

year to Mar

Standard ratios

	Hero Honda					Bajaj Auto			Maruti Suzuki India		
	FY09A	FY10A	FY11F	FY12F	FY13F	FY11F	FY12F	FY13F	FY10F	FY11F	FY12F
Performance											
Sales growth (%)	18.9	28.7	21.9	11.2	8.99	40.1	13.4	12.2	42.8	18.8	16.3
EBITDA growth (%)	23.7	61.8	6.75	12.4	6.57	28.8	8.98	9.84	110.9	-5.83	23.9
EBIT growth (%)	25.2	68.4	6.35	12.1	6.05	29.8	8.85	9.95	166.6	-11.4	20.9
Normalised EPS growth (%)	32.4	74.1	10.8	15.3	8.62	32.2	10.9	11.2	83.2	-7.16	18.3
EBITDA margin (%)	13.9	17.4	15.3	15.4	15.1	20.0	19.2	18.8	13.5	10.7	11.4
EBIT margin (%)	12.4	16.2	14.2	14.3	13.9	19.1	18.3	18.0	10.8	8.02	8.34
Net profit margin (%)	10.4	14.1	12.8	13.3	13.2	14.8	14.4	14.3	8.63	6.75	6.87
Return on avg assets (%)	19.7	33.5	31.4	27.3	23.4	25.8	23.6	22.2	14.7	10.9	11.3
Return on avg equity (%)	37.8	61.4	57.4	46.9	38.6	66.7	51.5	43.0	24.3	18.6	18.6
ROIC (%)	201.6	466.3	327.5	296.2	337.2	212.3	167.8	113.9	38.5	30.4	27.3
ROIC - WACC (%)	188.4	453.0	314.3	283.0	324.0	197.8	153.3	99.4	25.3	17.2	14.0
				year to Mar			year to Mar			year to Mar	
Valuation											
EV/sales (x)	2.48	1.96	1.53	1.28	1.09	2.42	2.09	1.80	1.08	0.91	0.78
EV/EBITDA (x)	17.8	11.2	10.0	8.31	7.25	12.1	10.9	9.57	7.95	8.43	6.80
EV/EBITDA @ tgt price (x)	22.7	14.2	12.8	10.8	9.58	8.91	7.95	6.91	7.43	7.88	6.35
EV/EBIT (x)	19.9	12.1	10.8	8.99	7.88	12.7	11.4	10.0	10.0	11.3	9.33
EV/invested capital (x)	70.1	45.9	35.0	34.8	28.9	29.5	17.8	13.8	5.21	3.85	2.94
Price/book value (x)	8.95	9.82	6.61	4.84	3.76	9.73	7.07	5.43	3.23	2.72	2.30
Equity FCF yield (%)	4.15	5.89	6.83	8.59	8.88	4.99	4.47	5.80	5.29	1.00	1.08
Normalised PE (x)	26.5	15.2	13.8	11.9	11.0	17.6	15.9	14.3	14.7	15.9	13.4
Norm PE @tgt price (x)	33.0	18.9	17.1	14.8	13.6	13.3	12.0	10.8	13.9	15.0	12.7
Dividend yield (%)	1.17	6.46	2.00	2.47	2.70	1.83	2.08	2.33	0.46	0.46	0.63
				year to Mar			year to Mar			year to Mar	
Per share data						Solvency					
Tot adj dil sh, ave (m)	199.7	199.7	199.7	199.7	199.7	Net debt to equity (%)	-92.3	-85.0	-87.0	-91.4	-92.5
Reported EPS (INR)	64.2	111.8	123.9	142.8	155.1	Net debt to tot ass (%)	-57.8	-48.7	-55.4	-62.8	-66.4
Normalised EPS (INR)	64.2	111.8	123.9	142.8	155.1	Net debt to EBITDA	-2.05	-1.06	-1.52	-1.93	-2.37
Dividend per share (INR)	20.0	110.0	34.0	42.0	46.0	Current ratio (x)	2.13	1.81	2.28	2.76	3.14
Equity FCF per share (INR)	70.7	100.3	116.3	146.4	151.3	Operating CF int cov (x)	-7.72	-10.5	-9.43	-8.19	-7.00
Book value per sh (INR)	190.3	173.5	257.7	351.6	453.1	Dividend cover (x)	2.74	0.87	3.12	2.92	2.89
				year to Mar						year to Mar	

Priced as follows: HROH.BO - Rs1703.30; BAJA.BO - Rs3004.00; MRTI.BO - Rs1302.55
Source: Company data, RBS forecasts

Valuation methodology

Economic Profit Valuation			Discounted Cash Flow Valuation		
	Rs m	%		Rs m	%
Adjusted Opening Invested Capital	7672.1	2	Value of Phase 1: Explicit (2011 to 2013)	45063.5	11
NPV of Economic Profit During Explicit Period	44164.8	11	Value of Phase 2: Value Driver (2014 to 2024)	201152.0	51
NPV of Econ Profit of Remaining Business (1, 2)	112190.2	29	Value of Phase 3: Fade (2025 to 2035)	134773.6	34
NPV of Econ Profit of Net Inv (Grth Business) (1, 3)	228683.9	58	Terminal Value	11720.9	3
Enterprise Value	392711.1	100	Enterprise Value	392710.0	100
Plus: Other Assets	0.0	0	FCF Grth Rate at end of Phs 1 implied by DCF Valuation		7.7
Less: Minorities	0.0	0	FCF Grth Rate at end of Phs 1 implied by Current Price		5.8
Less: Net Debt (as at 30 Jul 2010)	-29462.5	-8			
Equity Value	422173.5	108			
No. Shares (millions)	199.5				
Per Share Equity Value	2116.16				
Current Share Price	1703.30				

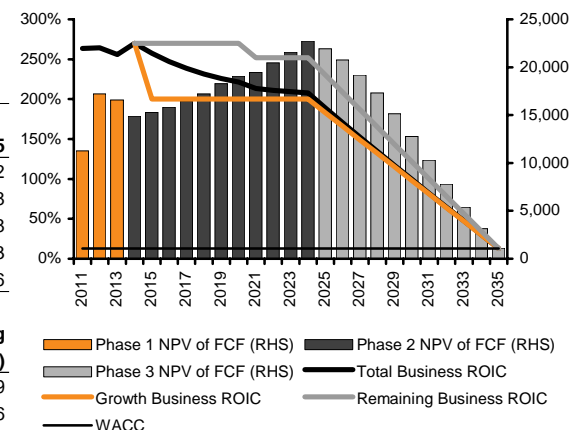
Sensitivity Table

WACC	No of Years in Fade Period				
	15	18	20	23	25
10.8%	2996.03	3356.43	3613.52	4026.29	4320.72
11.8%	2680.02	2969.23	3172.65	3494.71	3721.28
12.8%	2409.79	2642.56	2804.07	3056.35	3231.48
13.8%	2177.78	2365.68	2494.36	2692.75	2828.73
14.8%	1977.82	2129.94	2232.80	2389.42	2495.46

Performance Summary

	2011	2012	2013	Phase 2 Avg (2014 - 2024)
Invested Capital Growth (%)	11.8	9.5	3.2	20.9
Operating Margin (%)	14.2	14.3	13.9	14.6
Capital Turnover (x)	27.8	27.6	27.5	24.0

Returns, WACC and NPV of Free Cash Flow



Source: Company data, RBS forecasts

- In periods following the Explicit Period i.e. Phase 2 and Phase 3
- Remaining Business is defined as Capital as at the end of Phase 1 and capex = depreciation thereafter
- Net Investment is defined as capex over and above depreciation after Phase 1

Company description

Hero Honda is the largest Indian two-wheeler company with an overall market share of 48%. The company is a joint venture between India's Hero Group, run by the Munjals, and Honda of Japan. While the Munjals concentrate on the day-to-day management of operations, Honda provides technology support. Hero Honda focused only on motorcycles until now, but it has recently entered the high-growth scooter segment. With the launch of a third plant in a tax-haven state, the company plans to continue its volume momentum trend through its widespread rural network.

Buy

Price relative to country



Strategic analysis

Average SWOT company score:

3

Shareholding as of June 2010

Strengths

4

Hero Honda has the largest customer base in the Indian two-wheeler industry and enjoys strong customer goodwill. We believe this is key to it maintaining its leadership status.

Weaknesses

2

Poor presence in the premium motorcycle segment is an apparent weakness for Hero Honda, as is its dependence upon Honda Japan for new models.

Opportunities

2

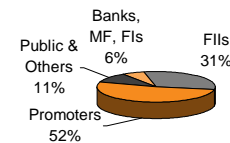
An extended product portfolio and new plant capacity should help the company build on its leadership position. Entry into the scooter market should help it leverage its brand image and customer goodwill.

Threats

2

Entry of MNCs such as Suzuki and Honda into the Indian motorcycle market is a significant threat to Hero Honda. Tata's mini car (for Rs100,000) could lead to faster upgrades by two-wheeler owners to cars, and thus have an impact on two-wheeler replacement demand.

Scoring range is 1-5 (high score is good)



Source: Company data

Market data

Headquarters

34, Community Centre, Basant Lok, Vasant Vihar, New Delhi.110057

Website

www.herohonda.com

Shares in issue

199.7m

Freefloat

48%

Majority shareholders

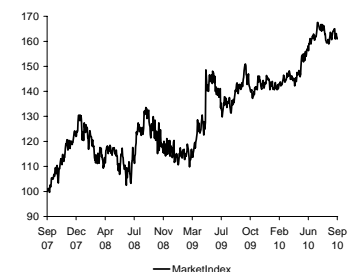
Copthall (4%), Aberdeen (2%), Europacifico Growth (2%)

Country view: India

The macro picture for India has been constructive recently, with GDP and industrial production tracking in line with expectations, while portfolio allocators continue to favour the market for its domestic consumption orientation. However, these positives have already been priced in and we believe risks are rising from the increasing double deficit, demanding valuations and tightening liquidity.

The country view is set in consultation with the relevant company analyst but is the ultimate responsibility of the Strategy Team.

Country rel to Asia Pacific



Competitive position

Average competitive score:

2+

Broker recommendations

Supplier power

4+

Component suppliers have negligible power as they are highly dependent upon the company. This is one reason why Hero Honda has managed its raw material costs well.

Barriers to entry

2+

No defensible entry barriers as two-wheeler technology is readily available. Capital cost for product development is also low. But distribution and service network are major barriers to building size.

Customer power

2-

A low entry barrier has resulted in increasing competition in the sector. As a result, wide choices are available to customers. Also, low differentiation results in poor bargaining power.

Substitute products

2+

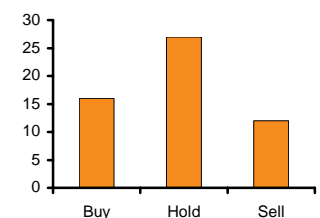
Scooters are motorcycle substitutes. Ungeared scooters in particular, targeted at women and middle-aged men, may take off. Low-cost cars like the Nano and electric two-wheeler are emerging as threats.

Rivalry

2-

Low product differentiation and very few defensible entry barriers have resulted in intense rivalry in the sector. However, low maintenance cost and sustained product performance build brand value.

Scoring range 1-5 (high score is good) Plus = getting better Minus = getting worse



Source: Bloomberg

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