

May 15, 2007

Stock Rating  
Equal-weight

Industry View  
In-Line

## Bajaj Auto Ltd.

### Core Auto Ops Valuation Post Demerger a Concern

#### What's Changed

Rating	<b>Overweight to Equal-weight</b>
Price Target	<b>Rs3,000.00 to Rs2,660.00</b>
Industry View	<b>Attractive to In-Line</b>
EPS F07E,F08E,F09E	<b>Down 1.9%, 11.7%, 18.7%</b>

**Conclusion:** We are downgrading Bajaj Auto to Equal-weight and revising our target price to Rs2,660. We believe investors should focus not only on the valuation of non-automotive operations if the de-merger proposal goes through, but, more importantly, the value of the underlying core automotive operations. We estimate the non-automotive operations valuation could range from Rs908 to Rs1,280 per share depending on the valuation we ascribe to Insurance JVs. Our downgrade essentially reflects our concerns on core implied automotive operations. With core earnings (down to 17.3% CAGR F2007-09E from 20% CAGR in F2003-07) and volume (down to 10.9% CAGR F2007-09E from 21.4% in F2003-07) growth coming off, the valuation multiple on core operations could potentially get de-rated. Further, with close to Rs30.4 per share or 92% of core automotive earnings growth over F2007-09E coming from fiscal incentives, any variance to our base case assumptions could lead to a significant earnings impact.

We utilize a 1-year forward PE multiple of 13x to value core automotive operations at Rs1,577 per share. This compares well with the past historical trend when Bajaj Auto has traded at an average of a 13.8x PE multiple when earnings growth has been muted.

**Implications:** We believe investors should book profits as the stock performance could be capped once the de-merger proposal is announced, as there are no near-term positive catalysts. Further, there is an outside chance that the de-merger proposal does not go through, then downside risk for the stock is high.

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#### Key Ratios and Statistics

Reuters: BJAT.BO Bloomberg: BJA IN

#### India Two-Wheelers

Price target	Rs2,660.0
Shr price, close (May 14, 2007)	Rs2,668.05
Mkt cap, curr (mn)	Rs269,953
52-Week Range	Rs3,325.0-2,085.0
Sh out, basic, curr (mn)	101.2
EV, curr (mn)	Rs227,935

Fiscal Year (Mar)	2006	2007e	2008e	2009e
ModelWare EPS (Rs)*	105.5	119.4	147.7	168.2
Prior ModelWare EPS (Rs)	-	121.6	168.1	208.0
Revenue, net (Rs mn)	76,290	93,604	105,833	118,660
ModelWare net inc (Rs mn)	10,674	12,076	14,946	17,020
P/E	26.0	22.4	18.1	15.9
P/BV	5.8	4.9	4.1	3.4
EV/EBITDA	17.9	16.1	13.4	11.4
Div yld (%)	1.5	1.5	1.5	1.6

\* = Please see explanation of Morgan Stanley ModelWare later in this note.  
e = Morgan Stanley Research estimates

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## Financial Summary

### Profit and Loss Statement

(Rs Min)	F2006	F2007E	F2008E	F2009E
Total Income	76,290	93,604	105,833	118,660
Total Expenses	63,116	79,381	89,149	99,739
Material Costs	53,246	66,740	74,865	83,839
Employee Costs	2,741	3,003	3,393	3,834
Power & Fuel	591	725	820	919
Other Manufacturing Expenses	742	911	1,030	1,155
Admn, Selling & Distn	5,796	8,002	9,041	9,992
Operating Profit	13,174	14,222	16,684	18,922
Int & Other Income	4,234	4,783	5,069	4,995
Depreciation	1,910	2,014	2,461	2,961
Interest	3	34	20	22
PBT	15,494	16,957	19,273	20,933
Adj Tax	4,633	4,539	4,581	4,828
Core PAT	10,861	12,418	14,692	16,105
Contr from Subsidiaries	-187	-342	254	915
Consolidated PAT	10,674	12,076	14,946	17,020
Extraordinaries	372	267	417	438
Rep PAT (Standalone)	11,233	12,685	15,109	16,543
Rep PAT (Consolidated)	11,046	12,343	15,363	17,458

### Balance Sheet

Balance Sheet	F2006	F2007E	F2008E	F2009E
Net Fixed Assets	11,572	11,586	14,601	17,115
Investments	13,756	13,256	12,756	12,256
Total Long Term Assets	25,327	24,842	27,357	29,371
Receivables	3,016	2,626	3,753	3,399
Inventories	2,729	3,425	3,533	4,269
Cash & Cash Eqv	45,448	47,929	55,878	66,612
Other Current Assets	21,995	27,997	30,432	33,496
Total Current Assets	73,187	81,977	93,596	107,777
Curr Liab & Provns	35,448	33,991	35,253	36,752
Net Current Assets	37,740	47,986	58,344	71,025
Total Assets	63,067	72,828	85,700	100,396
Share Capital	1,012	1,012	1,012	1,012
Reserves & Surplus	46,508	54,236	64,985	77,597
Share Holders Funds	47,520	55,248	65,996	78,609
Net Deferred Tax	876	458	-17	-534
Secured Loans	0	0	0	0
Unsecured Loans	14,671	17,121	19,721	22,321
Total Debt	14,672	17,122	19,722	22,322
Total Liabilities	63,067	72,828	85,700	100,396

### Cash Flow Statement

(Rs Min)	F2006	F2007E	F2008E	F2009E
<b>CASH FLOW FROM OPERATIONS</b>				
Net Profit	11,046	12,343	15,363	17,458
Depreciation	1,910	2,014	2,461	2,961
Deferred Tax	(523)	(417)	(476)	(517)
(Inc)/dec in Net WC	(4,579)	7,765	2,408	1,947
<b>Total</b>	<b>17,011</b>	<b>6,175</b>	<b>14,939</b>	<b>17,955</b>
<b>CASH FLOW FROM INVESTING ACTIVITIES</b>				
Inc)/(dec) of F Assets	2,033	2,029	5,475	5,475
Inc)/(dec) of Invntments	2,036	(500)	(500)	(500)
Inc)/(dec) in others	0	0	0	0
<b>Total</b>	<b>4,069</b>	<b>1,529</b>	<b>4,975</b>	<b>4,975</b>
<b>CASH FLOW FROM FINANCING ACTIVITIES</b>				
Inc)/(Decr) of Equities	(569)	0	0	0
Inc)/(Decr) of ST Debt	0	0	0	0
Inc)/(Decr) of LT Debt	2,401	2,450	2,600	2,600
Dividends	(4,615)	(4,615)	(4,615)	(4,846)
<b>Total</b>	<b>(2,783)</b>	<b>(2,165)</b>	<b>(2,015)</b>	<b>(2,246)</b>
Net change in cash	10,160	2,481	7,949	10,734
Cash & Eqv at beginning of year	35,288	45,448	47,929	55,878
Cash & Eqv at year-end	45,448	47,929	55,878	66,612

### Ratio Analysis

	F2006	F2007E	F2008E	F2009E
Per Share				
Core EPS	78.0	88.1	107.0	121.2
MW EPS	105.5	119.4	147.7	168.2
Book Value	469.7	546.0	652.3	776.9
DPS	40.0	40.0	40.0	42.0
Valuation				
P/E	26.0	22.4	18.1	15.9
P/BV	5.8	4.9	4.1	3.4
EV/EBIDTA	17.9	16.1	13.4	11.4
Returns				
EBIDTA Margin	17.3	15.2	15.8	15.9
ROCE	18.4	18.3	18.6	17.3
ROE	23.9	23.5	24.7	23.5
ROA	18.0	17.8	18.9	18.3
NPM	14.2	13.3	13.9	13.6
Dividend Yield	1.5	1.5	1.5	1.6
Capitalisation & Coverage				
Total Debt/Equity	0.3	0.3	0.3	0.3
Equity/ Net Assets	0.8	0.8	0.8	0.8
Turnover / Gross Block	3.0	3.5	3.3	3.2

Source: Company data, E = Morgan Stanley Research Estimates

## Investment Case

### Summary & Conclusions

We are downgrading Bajaj Auto to Equal-weight and cutting our target price to Rs2,660. We believe investors should focus not only on the valuation of non-automotive operations if the de-merger (i.e., to carve out marketable investments of nearly Rs80-85bn, as well as its captive finance company and insurance operations into a separate company) proposal goes through, but, more importantly, the value of the underlying core automotive operations. We estimate non-automotive operations valuation could range from Rs908 to Rs1,280 per share depending on the valuation we ascribe to Insurance JVs. (refer to Exhibit 8 for a valuation of the company post de-merger. Our downgrade essentially reflects our concerns over core implied automotive operations. With core earnings (down to 17.3% CAGR F2007-09E from 20% CAGR in F2003-07) and volume (down to 10.9% CAGR F2007-09E from 21.4% in F2003-07) growth coming off, the valuation multiple on core operations could potentially get de-rated (if history is to repeat itself) adding further risk to the near term stock performance (refer to Exhibit 2).

We utilize a 1-year forward PE multiple of 13x to value core automotive operations at Rs1,577 per share. This compares well with past historical trends when Bajaj Auto has traded at an average 14.7x PE multiple when earnings growth has been muted.

Further, our earnings are highly sensitive to the fiscal incentives generated from the new Uttaranchal plant. With close to Rs30.4 per share or 92% of core automotive earnings growth over F2007-09E coming from fiscal incentives, we could see volatility in earnings near term if our assumptions prove to be aggressive (Exhibit 4).

We are not turning outright negative on the stock as we believe growth in export markets, relatively strong financial condition, pipeline of new product launches and increasing availability of finance through its captive finance arm will provide support to earnings.

We believe investors should book profits as stock performance could be capped once the de-merger proposal is announced, as there are currently no near-term positive catalysts. Further, if the de-merger proposal does not go through, we believe the reaction of the stock would be much more severe on the downside.

We are reducing our volume estimates by 16% and 23% for F08 and F09 and earnings estimates by 12% and 19% for F08 and F09, respectively. This reflects the fiscal benefits from the Uttaranchal operations, stronger export volume growth (Nigeria and Indonesia) offset by intense competition and higher launch (product development and advertising) expenses.

Exhibit 1

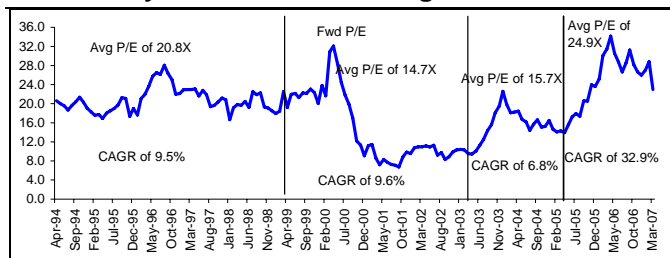
### Changes v/s Last Estimates

	F2008E	F2009E	YoY
<b>Old</b>			
Volumes			
Motorcycles	3,172,122	3,838,934	21.0%
Scooters	62,841	78,551	25.0%
Two Wheelers	3,234,963	3,917,485	21.1%
Three Wheelers	362,840	406,733	12.1%
Total Vehicles	3,597,803	4,324,218	20.2%
EBITDA Margins	17.30%	18%	0.7%
Core EPS	129.1	162.7	26.0%
Consol EPS	168.1	208	23.7%
<b>New</b>			
Volumes			
Motorcycles	2,668,362	2,963,259	11.1%
Scooters	22,482	23,883	6.2%
Two Wheelers	2,690,844	2,987,142	11.0%
Three Wheelers	339,485	358,653	5.6%
Total Vehicles	3,030,329	3,345,795	10.4%
EBITDA Margins	15.76%	15.95%	0.2%
Uttaranchal Fiscal benefits contribution to margins	0.8%	0.8%	0.1%
Core EPS	107.0	121.2	13.2%
Consol EPS	147.7	168.2	13.9%
<b>Change</b>			
Volumes			
Motorcycles	-15.9%	-22.8%	
Scooters	-64.2%	-69.6%	
Two Wheelers	-16.8%	-23.7%	
Three Wheelers	-6.4%	-11.8%	
Total Vehicles	-15.8%	-22.6%	
EBITDA Margins	-1.5%	-2.1%	
Core EPS	-17.1%	-25.5%	
Consol EPS	-12.1%	-19.1%	

Source: Company data, E = Morgan Stanley Research Estimates

Exhibit 2

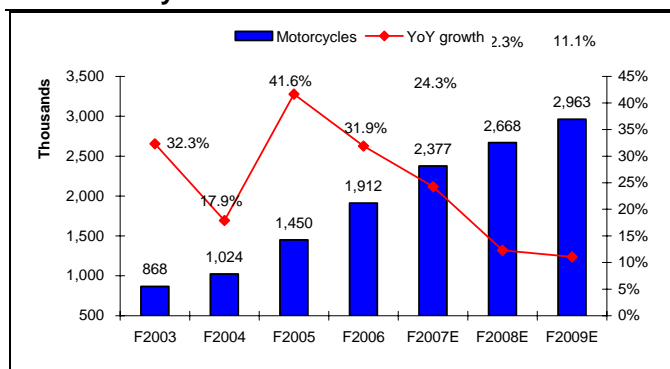
**Forward 1 yr P/E on Core Earnings**



Source: Company data, Morgan Stanley Research

Exhibit 3

**BAL Motorcycle Sales and YoY Growth**



Source: Company data, E = Morgan Stanley Research Estimates

Exhibit 4

**Sensitivity of Earnings to Fiscal benefits of Uttaranchal**

	F2008	F2009
<b>As per our present estimates (localization at 75%)</b>		
Production	600,000	800,000
Tax Holiday on Profits	547	747
Savings on Excise Duty	570	757
Savings on Sales Tax	242	216
Total Benefits	1,359	1,721
Per Share	13.5	17.0
Core EPS	107.0	121.2
Impact on EPS	12.6%	14.1%

**If production reduces by 10% (localization at 50%)**

Production	540,000	720,000
Tax Holiday on Profits	517	714
Savings on Excise Duty	540	724
Savings on Sales Tax	229	207
Total Benefits	1,286	1,645
Per Share	12.7	16.3
EPS	107.0	121.2
Impact on EPS	11.9%	13.4%

**If production increases by 10% (localization at 100%)**

Production	660,000	880,000
Tax Holiday on Profits	638	879
Savings on Excise Duty	660	885
Savings on Sales Tax	280	253
Total Benefits	1,578	2,017
Per Share	15.6	20.0
EPS	107.0	121.2
Impact on EPS	14.6%	16.5%

Source: Company data, Morgan Stanley Research

**Life Insurance operations to primarily drive value of non-automotive operations.** According to our India Banking analyst, Anil Agarwal, the economic value of Bajaj Auto's life insurance operations is Rs352 per share (we assume only 51% of the overall value as Allianz; the JV partner has paid an option premium for raising their stake to 49% whenever regulation allows it). Anil has utilized a net business multiplier of 15x for Bajaj Auto Life Insurance operations, a 32% discount to its domestic peers given the preponderance of single premium policies on its books, which has a relatively lower margin policy compared to standard insurance policies. This compares well with its regional peers, which are trading at an average implied net business multiplier of 11.6x versus our estimated average 15x multiple. On a bull and bear case scenario, the contribution could range from Rs178 (bear) to Rs551 (bull) for a net business multiplier of 12x (bear) to 18x (bull), as the underlying premium growth accelerates.

Exhibit 5

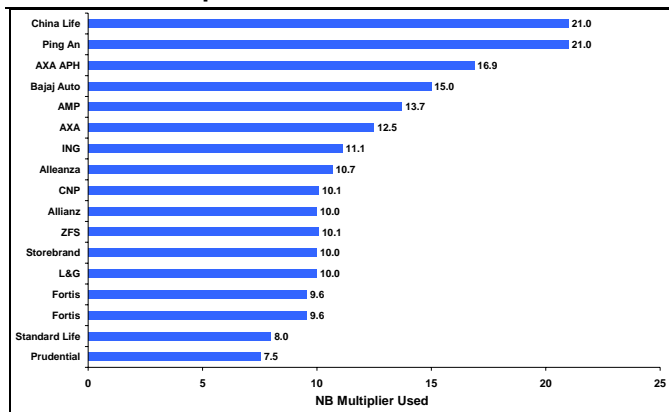
**Life Insurance Valuation**

Rs Mn	Bajaj		
	Bear	Base	Bull
Embedded Value	2,090	2,090	2,090
New Business Premiums	25,017	32,979	37,371
---New Premium CAGR, F2006 - F2008	35%	55%	65%
PV of 1 Years New Business	3,252	4,947	6,353
---NBAP Margin	13%	15%	17%
New Business Multiplier	12	15	18
PV of new Business	39,027	74,202	114,356
Appraisal Value			
---Rs. Mn	41,117	76,292	11,6446
---US \$Mn	934	1734	2647
Share of Domestic Player	30,426	56,456	86,170
Investment	3,698	3,698	3,698
Economic Profit of domestic player	26,728	52,758	82,472
Economic Interest (51%)	18,060	35,647	55,724
Per Share Value	178	352	551

Source: Company data, Morgan Stanley Research

Exhibit 6

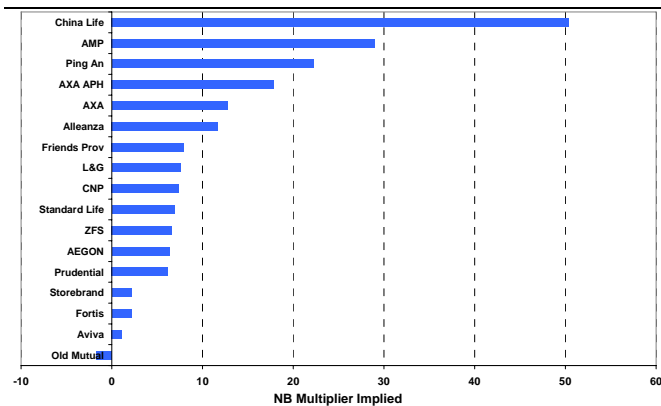
**Net Business Multiplier Used for Regional Life Insurance Companies**



Source: Company data, Morgan Stanley Research

Exhibit 7

**Net Business Multiplier Implied by Current Market Prices**



Source: Company data, Morgan Stanley Research

**Valuations:** We value Bajaj Auto's core business on a PE basis, but value the non-automotive company based on the value of its various operations (insurance and financing operations) and cash transferred as part of the de-merger.

We utilize a 1-year forward PE multiple of 13x to value core automotive operations at Rs1,577 per share. This compares well with past historical trends when Bajaj Auto has traded at an average of a 14.7x PE multiple when earnings growth has been muted.

We value cash and marketable securities at market value as of 31st March 2007 after adjusting for the ICICI stock performance (as it constitutes close to 50% of overall cash and marketable securities; refer to Exhibit 9 for details). We utilize the current market capitalization to value the captive finance arm, Bajaj Auto Finance, and a PE multiple of 13x to value the general insurance operations (51% economic holding, as Allianz has an option to increase its stake to 49% without paying current value per share). We utilize the valuation work done by our banking analyst, Anil Agarwal, to value the life insurance operations at Rs352 per share.

The key downside risks to our price target are the de-merger proposal falling flat, leading to lower value per share as core earnings growth has come off. Further, with close to Rs30.4 per share or 92% of core automotive earnings growth over F2007-09E coming from fiscal incentives, any variance to our base case assumptions could lead to significant earnings impact, both up and down. Please refer to Exhibit 4 for details of earnings sensitivity to various assumptions.

Exhibit 8

**BAL Sum of Parts Valuation**

Business Segment	Basis	Rs per share
Core Auto Business	P/E of 13x on F2008 earnings	1,577
<b>Non Core Business</b>		
Auto Finance	Market price of Rs 465	45
General Insurance	P/E of 13.5x on F2008 earnings	57
Life Insurance	Refer Exhibit 5 of Note	352
Net Cash per share	Refer Exhibit 9	629
		2,660

Source: Company data, Morgan Stanley Research

Exhibit 9

**Computation of Net Cash per Share**

	Dec 06	Mar 07
Cash + Mktble Sec	84,679	80,621
ICICI Bank	33,433	32,032
Others (Based on Sensex movement)	51,246	48,589
Less Debt		(17,122)
Net Cash		63,500
Per Share		629

Source: Morgan Stanley Research

**Bull-Bear Case Scenario**

**Bear Case Scenario:** As per Exhibit 5, if we apply a net business multiplier of 12x, we arrive at a life insurance valuation of Rs178 per share. If we assume production levels in Uttaranchal reduce to 540,000 in F2008 with localization at 50%, this would lead to the core auto business contributing Rs1,556 per share or Rs21 less per share than our base case, yielding a bear case value of Rs2,464.

**Bull Case Scenario:** if we apply a net business multiplier of 18x, we arrive at a life insurance valuation of Rs551 per share. If we assume production levels in Uttaranchal increase to 660,000 in F2008 with localization at 100%, this would lead to the core auto business contributing Rs1,598 per share or Rs21 more per share than our base case, yielding a bull case value of Rs2,879.

Exhibit 10

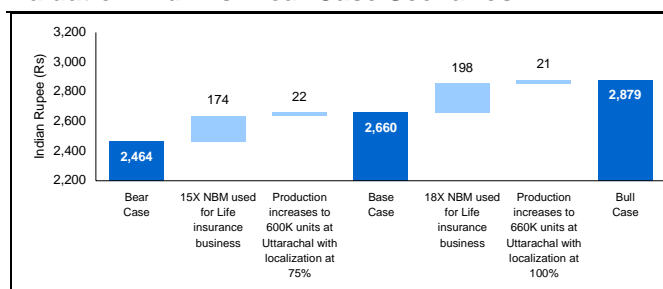
**Scenario Analysis of Bull, Base and Bear Cases**

Sum of Parts Valuation	Basis	Base	Bear	Bull
<b>Core Automotive Business</b>				
Auto business	P/E of 13x on F2008 earnings	1,577	1,556	1,598
<b>Non-Core Business</b>				
Auto Finance	Market price of Rs 465	45	45	45
General insurance	P/E of 13.0x on F2008 earnings	57	57	57
Life Insurance	Refer Exhibit 5	352	178	551
Net Cash per share	Refer Exhibit 9	628	628	628
Total Non Core Business		1,082	908	1,281
Per Share (Rs)		2,660	2,464	2,879

Source: Company data, Morgan Stanley Research

Exhibit 11

**Valuation: Bull vs. Bear Case Scenarios**



Source: Company data, Morgan Stanley Research



**Morgan Stanley ModelWare is a proprietary analytic framework that helps clients uncover value, adjusting for distortions and ambiguities created by local accounting regulations.** For example, ModelWare EPS adjusts for one-time events, capitalizes operating leases (where their use is significant), and converts inventory from LIFO costing to a FIFO basis. ModelWare also emphasizes the separation of operating performance of a company from its financing for a more complete view of how a company generates earnings.

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### Global Stock Ratings Distribution

(as of April 30, 2007)

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Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total	% of Rating Category
<b>Overweight/Buy</b>	<b>850</b>	<b>38%</b>	<b>291</b>	<b>42%</b>	<b>34%</b>
<b>Equal-weight/Hold</b>	<b>1008</b>	<b>45%</b>	<b>303</b>	<b>44%</b>	<b>30%</b>
<b>Underweight/Sell</b>	<b>368</b>	<b>17%</b>	<b>97</b>	<b>14%</b>	<b>26%</b>
<b>Total</b>	<b>2,226</b>		<b>691</b>		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

### Analyst Stock Ratings

Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Underweight (U or Under) - The stock's total return is expected to be below the total return of the relevant country MSCI Index, on a risk-adjusted basis, over the next 12-18 months.

More volatile (V) - We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst's view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "more volatile" can still perform in that manner.

Unless otherwise specified, the time frame for price targets included in this report is 12 to 18 months.

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Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

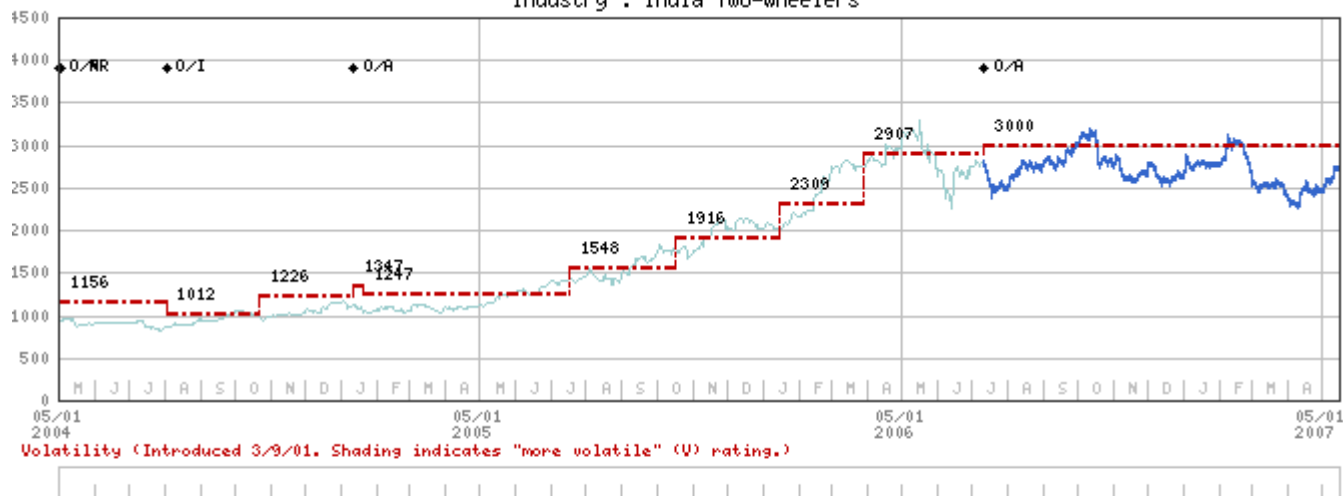
Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.

*Stock price charts and rating histories for companies discussed in this report are available at [www.morganstanley.com/companycharts](http://www.morganstanley.com/companycharts) or from your local investment representative. You may also request this information by writing to Morgan Stanley at 1585 Broadway, (Attention: Equity Research Management), New York, NY, 10036 USA.*



**Stock Price, Price Target and Rating History (See Rating Definitions)**

Bajaj Auto Ltd. (BJAT.BO) - As of 5/14/07 in INR  
Industry : India Two-Wheelers



Volatility (Introduced 3/9/01. Shading indicates "more volatile" (V) rating.)

Stock Rating History: 4/24/02 : 0/NR; 5/2/04 : 0/A; 8/2/04 : 0/I; 1/11/05 : 0/A; 7/11/06 : 0/A

Price Target History: 2/26/04 : 1156; 8/2/04 : 1012; 10/21/04 : 1226; 1/11/05 : 1347; 1/20/05 : 1247; 7/18/05 : 1548; 10/17/05 : 1916; 1/16/06 : 2309; 3/30/06 : 2907; 7/11/06 : 3000

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target --- No Price Target Assigned (NA)  
 Stock Price (Not Covered by Current Analyst) --- Stock Price (Covered by Current Analyst) ■  
 Stock Ratings abbreviated as below ( Effective 3/18/02, ratings appear as Stock Ratings/Industry View ) ♦  
 Stock Ratings as of 3/18/02: Overweight (O) Equal-weight (E) Underweight (U) More Volatile (V) No Rating Available (NAU)  
 Stock Ratings prior to 3/18/02: Strong Buy (SB) Outperform (OP) Neutral (N) Underperform (UP) No Rating Available (NAU)  
 Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

**Other Important Disclosures**

For a discussion, if applicable, of the valuation methods used to determine the price targets included in this summary and the risks related to achieving these targets, please refer to the latest relevant published research on these stocks. Research is available through your sales representative or on Client Link at [www.morganstanley.com](http://www.morganstanley.com) and other electronic systems.

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**Industry Coverage:India Two-Wheelers**

<b>Company (Ticker)</b>	<b>Rating (as of)</b>	<b>Price (05/14/2007)</b>
<b>Balaji Jayaraman, CFA</b>		
Bajaj Auto Ltd. (BJAT.BO)	E (05/15/2007)	Rs2,668.05
Hero Honda Motor Ltd (HROH.BO)	U (07/11/2006)	Rs690.1
TVS Motors (TVSM.BO)	E (05/15/2007)	Rs62.35

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