

Ashok Leyland

| | |
|--------------------|--------------|
| STOCK INFO. | BLOOMBERG |
| BSE Sensex: 11,724 | AL IN |
| | REUTERS CODE |
| S&P CNX: 3,430 | ASOK.BO |

30 August 2006

Buy

Rs40

Previous Recommendation: Buy

| | |
|-----------------------|----------|
| Equity Shares (m) | 1,221.6 |
| 52-Week Range | 54/23 |
| 1,6,12 Rel. Perf. (%) | 5/-9/-12 |
| M.Cap. (Rs b) | 48.6 |
| M.Cap. (US\$ b) | 1.0 |

| YEAR | NET SALES | PAT | EPS | EPS | P/E | P/BV | ROE | ROCE | EV/ | EV/ |
|-------|-----------|--------|------|------------|------|------|------|------|-------|--------|
| END | (RS M) | (RS M) | (RS) | GROWTH (%) | (X) | (X) | (%) | (%) | SALES | EBITDA |
| 3/06A | 52,477 | 2,837 | 2.3 | 21.7 | 17.1 | 3.4 | 21.6 | 19.6 | 0.9 | 8.5 |
| 3/07E | 61,831 | 4,125 | 3.1 | 34.2 | 12.8 | 3.2 | 25.3 | 24.6 | 0.8 | 6.9 |
| 3/08E | 69,586 | 4,676 | 3.5 | 13.4 | 11.3 | 2.9 | 25.4 | 27.6 | 0.6 | 5.7 |

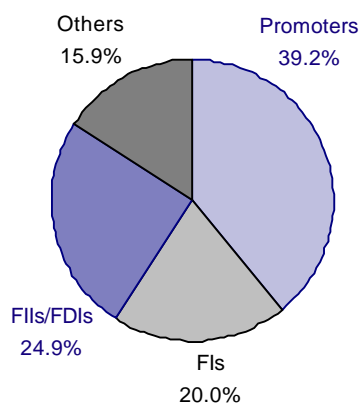
Witnessing strong volume growth: Post the ban on overloading in November 2005, Ashok Leyland has been reporting strong M&HCV sales. The company has maintained its strong growth momentum in FY07 as well, registering YTD volume growth of 26.7%. We are upgrading our volume forecast for FY07 by 5.9% to 72,411 units and for FY08 by 8.3% to 81,462 units. Our revised volume growth assumption translates into a residual growth of 14% for rest of FY07.

Product mix tilting towards heavier tonnage vehicles: Ashok Leyland's dependence of 16T trucks and passenger buses is declining, which is positive in our view. It has expanded its domestic market share in the 16.2-25 ton segment from 50.3% in 1QFY06 to 64.8% in 1QFY07. Further, sales in the 35 ton+ segment have also increased multifold. This segment constituted 15% of Ashok Leyland's domestic volumes in 1QFY07, up from just 3.7% in 1QFY06.

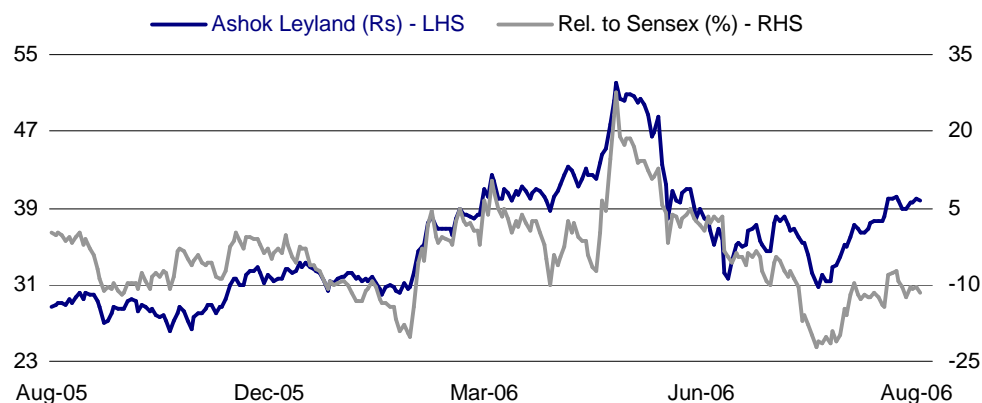
Avia acquisition to help boost exports: Ashok Leyland is in the process of acquiring Avia's truck business, which will give it a foothold in Eastern Europe. Avia's truck manufacturing facility has a capacity of 20,000 units. Besides boosting exports, Avia's acquisition would also help Ashok Leyland gain a presence in ICVs (7-11 ton). Ashok Leyland expects exports to constitute 25% of its total volumes by FY09, up from the current 10%.

Revising estimates upwards; Buy: Ashok Leyland's efforts to effectively manage costs should yield benefits in FY07 and FY08. We estimate a 90bp improvement in EBITDA margin over FY06-08. We have raised our EBITDA margin expectation by 20bp to 10.9% for FY07 and by 10bp to 11.2% for FY08. Our revised EPS estimates are Rs3.1 for FY07 and Rs3.5 for FY08. The stock trades at 12.8x FY07E and 11.3x FY08E EPS. We reiterate **Buy**.

SHAREHOLDING PATTERN (JUN.06)



STOCK PERFORMANCE (1 YEAR)



Witnessing strong volume growth

Post the ban on overloading in November 2005, Ashok Leyland has been reporting strong M&HCV sales. The company has maintained its strong growth momentum in FY07 as well, registering YTD volume growth of 26.7%. Considering the buoyant growth, we are upgrading our volume forecast for FY07 by 5.9% to 72,411 units and for FY08 by 8.3% to 81,462 units. Our revised volume growth assumption translates into a residual growth of 14% for rest of FY07.

| RESIDUAL GROWTH OF 14% REQUIRED TO MEET OUR FY07 ESTIMATE | | | |
|---|---------------|---------------|-------------|
| ASHOK LEYLAND | FY07 | FY06 | GR. (%) |
| July Sales (Units) | 5,231 | 4,283 | 22.1 |
| YTD FY07 Sales (Units) | 22,298 | 17,603 | 26.7 |
| Our FY07 Estimate Sales (Units) | 72,411 | 61,626 | 17.5 |
| Residual Growth Req. (%) | 14 | | |
| YTD HCV Sales (Units) | 22,183 | 17,433 | 27.2 |
| YTD LCV Sales (Units) | 115 | 170 | -32.4 |

Source: Company/ Motilal Oswal Securities

The company expects volumes of 75,000 vehicles (25% growth) for FY07 and 90,000 vehicles (16% growth) for FY08.

| OUR VOLUME EXPECTATIONS ARE LOWER THAN THE COMPANY'S | | |
|--|--------|--------|
| | FY07 | FY08 |
| Our Estimate (Units) | 72,411 | 81,462 |
| Company Expectations (Units) | 75,000 | 90,000 |
| % Difference | -3.5 | -9.5 |

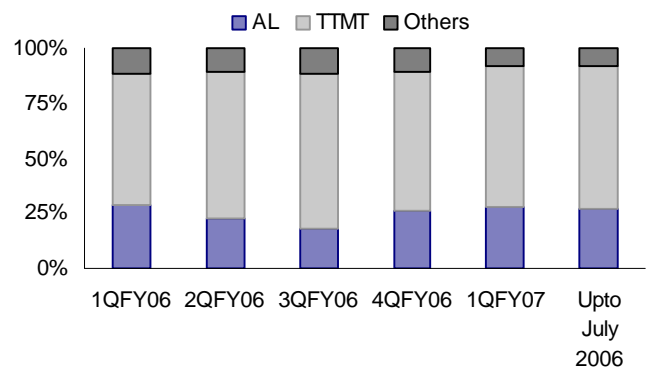
Source: Company/ Motilal Oswal Securities

Product mix tilting towards heavier tonnage vehicles

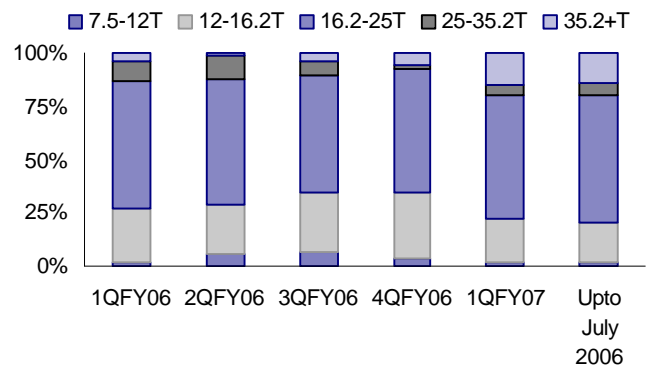
Ashok Leyland's dependence of 16T trucks and passenger buses is declining, which is positive in our view. The company is benefiting from the multifold increase in tractor-trailer sales, as well as from the strong demand for 16.2-25 ton rigid vehicles. It has expanded its domestic market share in the 16.2-25 ton segment from 50.3% in 1QFY06 to 64.8% in 1QFY07 (although its share has dipped for YTD FY07 to 61.5%).

Further, sales in the 35 ton+ segment have also increased multifold – an industry-wide phenomenon. This segment constituted 15% of Ashok Leyland's total volumes in 1QFY07 (14.4% YTD FY07), up from just 3.7% in 1QFY06.

M&HCV MARKET SHARE TREND (%)



ASHOK LEYLAND'S PRODUCT MIX (%)



Source: Company/ Motilal Oswal Securities

Currently, 18% of the CV population in India is above 15 years of age. Most of these are lower tonnage vehicles. As the ban on overloading has made it more economical for transporters to operate trucks with higher payloads, we expect greater demand for higher tonnage vehicles in the replacement market. The trend of higher tonnage CVs gaining market share has been evident since April 2006 and is likely to be sustained in our opinion. As far as Ashok Leyland is concerned, we expect strong demand growth for its *Artik*, *4018* and *Hippo Tipper*.

ASHOK LEYLAND'S OFFERINGS

| SEGMENT | GWV | ALL MODEL IN THE SEGMENT* | TYPICAL HAULAGE SEGMENT | TYPICAL APPLICATION |
|------------------|---------------|---------------------------|--|---|
| MCVs | 12-16.2 ton | ALL Comet | All terrain especially meant for hilly areas, highways, metallic roads and non-concretised roads, off-highway applications | Medium to heavy duty applications Cement, coal, construction material, Industrial goods Agricultural produce, Auto and Auto components, etc. |
| MAVs | 16.2-25 ton | ALL 2516H, | All terrain long distances, on and off highway application, metallic and non-concretised roads | Heavy density loads, cement concrete mixers, Cement-bulk & bags, construction material containers, tankers, petrochemicals & petroleum products, fertilizers, food grains, coal, timber, iron ore, minerals |
| Tractor trailers | 26.2-35.2 ton | ALL Artik 30.14 | All terrain long distances, highway application | Usually used by port cargo |
| | >35.2 ton | ALL 4018 | All terrain long distances, highway application | Usually used by port cargo |
| Tipper | 12-16.2 ton | ALL Comet Tipper | All terrain especially meant for hilly areas, for mining & construction | Usually used for mining and construction |
| | 16.2-25 ton | ALL Hippo Tipper | All terrain long distances, on and off highway application, metallic and non-concretised roads | Usually used for mining and construction |

*list is not exhaustive

Source: Crisinfac

Higher productivity; cost reduction to enhance margins

We expect cost reduction (e-sourcing of materials) and productivity improvement measures to drive up margins over the next two years. Employee cost has declined from 9.8% of sales in 1QFY06 to 9.1% in 1QFY07. Other expenses as a percentage of sales declined 210bp YoY to 9.1% in 1QFY07. While the management is confident that margins would expand by 200bp over the next two years, we estimate a 90bp margin improvement over FY06-FY08.

Also, the price increases announced by Ashok Leyland in April 2006 have been implemented in June 2006. If raw material prices increase considerably, there would be another price hike in FY07. Factoring in both higher than anticipated volume growth and price hikes, we have revised our net sales estimates for FY07 and FY08 by 4.7% and 4.9%, respectively. We have upgraded our EPS estimates by 8% for FY07 and by 6.6% for FY08.

REVISING ESTIMATES UPWARDS

| | OLD | REVISED | % CH. |
|---------------------|--------|---------|-------|
| FY07 | | | |
| Total Volumes (Nos) | 68,405 | 72,411 | 5.9 |
| Net Sales (Rs m) | 59,031 | 61,831 | 4.7 |
| EBITDA (Rs m) | 6,322 | 6,740 | 6.6 |
| Adj. PAT (Rs m) | 3,824 | 4,125 | 7.9 |
| EPS (Rs) | 2.9 | 3.1 | 8.0 |
| FY08 | | | |
| Total Volumes (Nos) | 75,245 | 81,462 | 8.3 |
| Net Sales (Rs m) | 66,325 | 69,586 | 4.9 |
| EBITDA (Rs m) | 7,336 | 7,794 | 6.2 |
| Adj. PAT (Rs m) | 4,375 | 4,676 | 6.9 |
| EPS (Rs) | 3.3 | 3.5 | 6.6 |

Source: Motilal Oswal Securities

Avia acquisition to help boost exports

Ashok Leyland is in the process of acquiring Avia's truck business, which will give it a foothold in Eastern Europe. Once the acquisition is completed, the company intends to shift Avia's press tool and dies to India. However, cab manufacturing is likely to be carried on in Europe. The longer-term plan is to bring Avia's cab into all of Ashok Leyland's products.

Avia’s truck manufacturing facility has a capacity of 20,000 units, but it is currently utilizing only 10% of its installed capacity. Over the next 12-18 months, Ashok Leyland plans to take this up to 30% and also expects to break even by then. Besides, boosting exports, Avia’s acquisition would also help Ashok Leyland gain a presence in ICVs (7-11 ton). For a presence in the sub-3.5 ton segment, however, the company may have to look at another acquisition.

Ashok Leyland expects exports to constitute 25% of its total volumes by FY09, up from the current 10%. To buoy exports, it is setting up an assembly unit in Dubai and a plant in South Africa. The company envisages export of 3,000 vehicles per annum to South Africa, which translates into a target of 20% share of the CV market there. Its focus on exports would help de-risk business revenues.

FOCUSING ON INCREASING SHARE OF EXPORTS



Source: Motilal Oswal Securities

Focus on non-cyclical segments to help hedge CV business risk

The company is also attempting to increase its focus on non-cyclical business sources – defense, spare parts, exports, industrial/marine engine sales, etc. Sales of ferrous castings, engines and spare parts constituted 15% of its gross sales in FY06.

Capacity expansion is on track

Ashok Leyland is undergoing capacity expansion in two phases. In the first phase, its capacity would go up from 77,200 units currently to 110,000 units in FY08 – an increase of 42.5%. In the second phase, the company would increase capacity by a further 40,000 units to 150,000 units besides expanding cab building capacity from 40,000 units to 100,000 units. The total outlay for these expansions would be Rs10b. To fund this capex and the acquisition of Avia, Ashok Leyland already got the board’s approval to raise US\$150m.

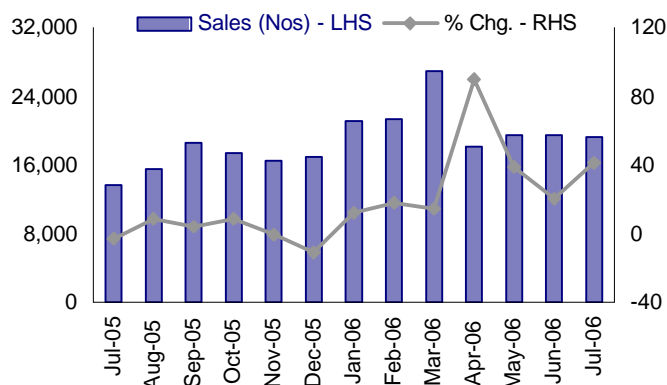
IndusInd stake sale is on the cards

Ashok Leyland is likely to sell its stake in IndusInd Bank, which could result in pre-tax gains of about Rs220m (not factored in our estimates).

Sector outlook positive

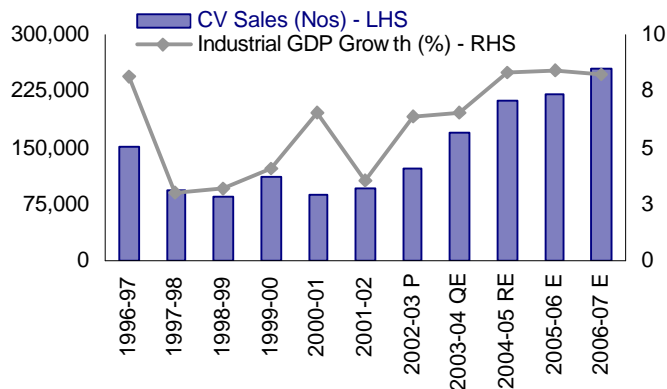
We remain positive on the prospects of the CV industry due to the ongoing infrastructure development activity in the country, and the continuing impact of the ban on overloading implemented last year. With industrial growth expected to remain at the high trend levels of recent years, the share of roads in total freight movement is expected to move up from 66-67% in 2004-05 to 71-72% in 2009-10.

TREND IN CV SALES GROWTH



Source: SIAM/ Motilal Oswal Securities

INDUSTRIAL GDP GROWTH VISA-VIS CV SALES



P; Provisional, Q; Quick estimate, RE; Revised estimates

Source: SIAM/ RBI/Motilal Oswal Securities

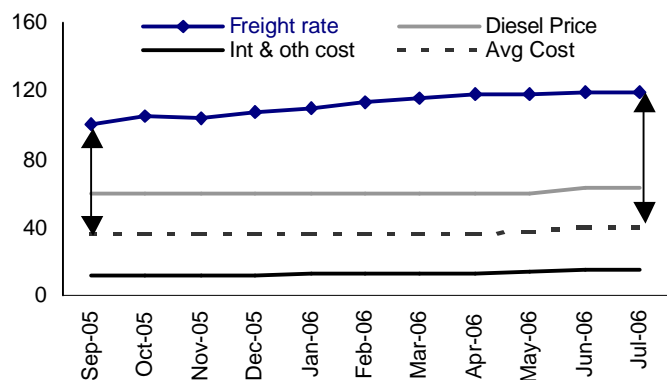
Policy changes may provide upside

Policy changes in the form of scrapping over-aged trucks may result in increased demand subject to stringent implementation. As per Cris-Infac estimates, over 18% of the CV population is above 15 years of age, which may mean annual replacement demand of 0.4m - 0.5m vehicles.

Freight rates remain strong

The freight rates have remained firm, thereby quelling any near-term concerns. Fears over lower freight operator profitability too are unfounded, as the rise in the input costs has yet not impacted their performance negatively. The freight rate rise over the past few months has been sufficient to ensure their profitability.

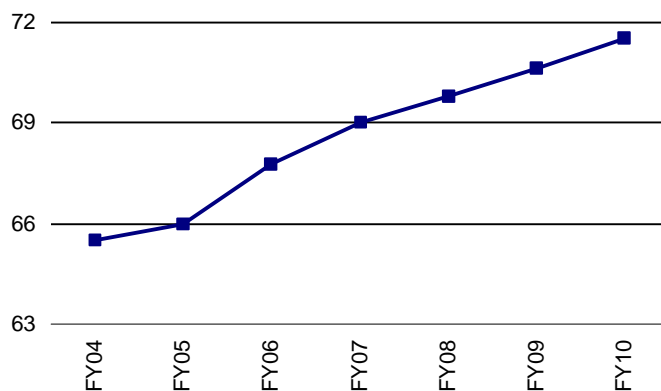
FREIGHT OPERATOR PROFITABILITY YET ON THE UPWARD TREND



Source: Company/ Motilal Oswal Securities

Road development, hub and spoke model, and need for last-mile transport mean that roads are expected to continue to gain share in cement and other industrial products and in consumer goods and capital goods due to a more suitable load and distribution network pattern.

SHARE OF ROAD TRANSPORT IN OVERALL FREIGHT MOVEMENT



Source: Cris-Infac

No major impact on cost of ownership of new CVs

We also believe that there is no significant impact on the cost of ownership of new commercial vehicles due to factors such as the rising interest rate and increased diesel prices.

OWNERSHIP COST OF A NEW COMMERCIAL VEHICLE

| | FY06 | RECENT PRICE HIKE |
|---------------------------------|---------|-------------------|
| Average Cost of CV (Rs) | 900,000 | 915,000 |
| Finance (%) | 90 | 90 |
| Loan Amount (Rs) | 810,000 | 823,500 |
| Interest Rate (%) | 11 | 13 |
| Duration (Months) | 60 | 60 |
| Monthly EMI (Rs) | 17,611 | 18,527 |
| Per Day Usage (km) | 280 | 280 |
| Fuel Efficiency (km/lt) | 4 | 4 |
| Diesel Price (per lt) | 37.6 | 39.7 |
| Fuel Cost per Month (Rs) | 78,960 | 83,286 |
| Annual Maintenance Cost (Rs) | 18,000 | 18,000 |
| Monthly Maintenance Cost (Rs) | 1,500 | 1,500 |
| Ownership Cost (per Month) (Rs) | 98,071 | 103,313 |
| % Increase | | 5.3 |

Source: Company/ Motilal Oswal Securities

With strong growth continuing to stream in, no significant increase in the ownership costs, and continued profitability of the truck operators, we maintain our bullish stance on the sector.

Valuation and view

Ashok Leyland's efforts to effectively manage costs should yield benefits in FY07 and FY08. We estimate a 90bp improvement in EBITDA margin over FY06-08. We have raised our EBITDA margin expectation by 20bp to 10.9% for FY07 and by 10bp to 11.2% for FY08.

We believe that the structural factors aiding CV industry growth are in place. We expect Ashok Leyland to maintain strong volume growth over the next two years. Our revised EPS estimates are Rs3.1 for FY07 and Rs3.5 for FY08. The stock trades at 12.8x FY07E and 11.3x FY08E EPS. We reiterate **Buy** with a target of Rs49.

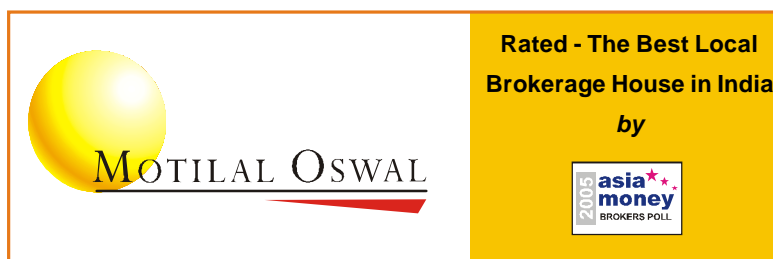
| INCOME STATEMENT | | | | | |
|------------------------------|---------------|---------------|---------------|---------------|---------------|
| (Rs Million) | | | | | |
| Y/E MARCH | 2004 | 2005 | 2006 | 2007E | 2008E |
| Net Sales | 33,920 | 41,824 | 52,477 | 61,831 | 69,586 |
| Change (%) | 25.7 | 23.3 | 25.5 | 17.8 | 12.5 |
| Raw Material | 23,228 | 29,729 | 37,690 | 44,085 | 49,545 |
| Employee Cost | 3,097 | 3,540 | 4,039 | 4,823 | 5,289 |
| Other Mfg. Expenses | 1,873 | 2,096 | 2,407 | 2,937 | 3,305 |
| Selling & Distribution | 1,775 | 2,230 | 2,940 | 3,246 | 3,653 |
| EBITDA | 3,946 | 4,228 | 5,401 | 6,740 | 7,794 |
| Change (%) | 23.2 | 7.2 | 27.7 | 24.8 | 15.6 |
| % of Net Sales | 11.6 | 10.1 | 10.3 | 10.9 | 11.2 |
| Depreciation | 965 | 1,092 | 1,260 | 1,387 | 1,505 |
| Interest & Finance Charge | 594 | 304 | 384 | 243 | 253 |
| Other Income | 572 | 554 | 330 | 620 | 643 |
| Non-recurring Expense | 95 | 95 | 85 | - | - |
| Non-recurring Income | - | 260 | 302 | - | - |
| PBT | 2,959 | 3,386 | 4,087 | 5,729 | 6,679 |
| Tax | 929 | 836 | 1,250 | 1,604 | 2,004 |
| Effective Rate (%) | 31.4 | 24.7 | 30.6 | 28.0 | 30.0 |
| Adj. PAT (bef. Extra) | 2,031 | 2,550 | 2,837 | 4,125 | 4,676 |
| % of Net Sales | 63.7 | 25.6 | 11.3 | 45.4 | 13.4 |
| Rep. PAT | 1,936 | 2,715 | 3,054 | 4,125 | 4,676 |

| BALANCE SHEET | | | | | |
|----------------------------------|---------------|---------------|---------------|---------------|---------------|
| (Rs Million) | | | | | |
| Y/E MARCH | 2004 | 2005 | 2006 | 2007E | 2008E |
| Share Capital | 1,189 | 1,189 | 1,222 | 1,324 | 1,324 |
| Reserves | 9,329 | 10,489 | 12,903 | 14,965 | 17,069 |
| Net Worth | 10,518 | 11,679 | 14,125 | 16,289 | 18,393 |
| Loans | 4,989 | 8,804 | 6,919 | 6,169 | 4,919 |
| Deferred Tax Liability | 1,803 | 1,708 | 1,797 | 1,797 | 1,797 |
| Capital Employed | 17,310 | 22,191 | 22,841 | 24,255 | 25,109 |
| Gross Fixed Assets | 18,756 | 20,023 | 21,385 | 24,199 | 25,249 |
| Less: Depreciation | 10,008 | 11,084 | 11,952 | 13,339 | 14,844 |
| Net Fixed Assets | 8,748 | 8,938 | 9,433 | 10,860 | 10,405 |
| Investments | 1,466 | 2,292 | 3,682 | 3,682 | 3,682 |
| Curr. Assets, L & Adv | 14,637 | 21,573 | 22,324 | 23,302 | 26,098 |
| Inventory | 5,069 | 5,681 | 9,026 | 9,317 | 10,486 |
| Sundry Debtors | 4,056 | 4,588 | 4,243 | 5,082 | 5,719 |
| Cash & Bank Balances | 3,250 | 7,967 | 6,029 | 8,713 | 9,703 |
| Loans & Advances | 2,261 | 3,337 | 3,026 | 190 | 190 |
| Current Liab. & Prov. | 8,327 | 11,657 | 14,085 | 13,662 | 15,149 |
| Sundry Creditors | 6,041 | 8,619 | 10,460 | 11,858 | 13,345 |
| Other Liabilities | 816 | 993 | 1,009 | 1,009 | 1,009 |
| Provisions | 1,470 | 2,045 | 2,616 | 794 | 794 |
| Net Current Assets | 6,310 | 9,916 | 8,239 | 9,641 | 10,949 |
| Miscellaneous Exp. | 323 | 193 | 73 | 73 | 73 |
| Application of Funds | 17,310 | 22,191 | 22,841 | 24,255 | 25,109 |

E: M O S t Estimates

| RATIOS | | | | | |
|---------------------------------|------------|------------|------------|------------|------------|
| Y/E MARCH | 2004 | 2005 | 2006 | 2007E | 2008E |
| Basic (Rs) | | | | | |
| EPS | 1.6 | 1.9 | 2.3 | 3.1 | 3.5 |
| Cash EPS | 2.5 | 3.1 | 3.4 | 4.2 | 4.7 |
| EPS Growth (%) | 70.8 | 17.2 | 21.7 | 34.2 | 13.4 |
| Book Value per Share | 8.8 | 9.8 | 11.6 | 12.3 | 13.9 |
| DPS | 0.8 | 1.0 | 1.3 | 1.7 | 2.1 |
| Payout (Incl. Div. Tax) % | 46.1 | 48.7 | 52.3 | 50.0 | 55.0 |
| Valuation (x) | | | | | |
| P/E | | 20.8 | 17.1 | 12.8 | 11.3 |
| Cash P/E | | 13.0 | 11.9 | 9.5 | 8.5 |
| EV/EBITDA | | 10.8 | 8.5 | 6.9 | 5.7 |
| EV/Sales | | 1.1 | 0.9 | 0.8 | 0.6 |
| Price to Book Value | | 4.0 | 3.4 | 3.2 | 2.9 |
| Dividend Yield (%) | | 2.5 | 3.3 | 4.2 | 5.3 |
| Profitability Ratios (%) | | | | | |
| RoE | 18.4 | 23.2 | 21.6 | 25.3 | 25.4 |
| RoCE | 20.5 | 16.6 | 19.6 | 24.6 | 27.6 |
| Leverage Ratio | | | | | |
| Debt/Equity (x) | 0.5 | 0.8 | 0.5 | 0.4 | 0.3 |

| CASH FLOW STATEMENT | | | | | |
|------------------------------|---------------|---------------|---------------|---------------|---------------|
| (Rs Million) | | | | | |
| Y/E MARCH | 2004 | 2005 | 2006 | 2007E | 2008E |
| OP/(Loss) before Tax | 2,981 | 3,136 | 4,141 | 5,352 | 6,289 |
| Depreciation & Amortisat | 965 | 1,092 | 1,260 | 1,387 | 1,505 |
| Direct Taxes Paid | -811 | -930 | -1,161 | -1,604 | -2,004 |
| (Inc)/Dec in Working Capi | 1,876 | 1,241 | -141 | 1,283 | -319 |
| Other Items | -120 | -365 | 957 | 0 | 0 |
| CF from Oper. Activi | 4,890 | 4,174 | 5,056 | 6,418 | 5,471 |
| Extra-ordinary Items | -95 | 165 | 217 | 0 | 0 |
| CF after EO Items | 4,795 | 4,339 | 5,273 | 6,418 | 5,471 |
| (Inc)/Dec in FA+CWIP | -777 | -1,671 | -2,317 | -1,400 | -1,050 |
| (Pur)/Sale of Invest. | 110 | -826 | -1,390 | 0 | 0 |
| CF from Inv. Activity | -667 | -2,497 | -3,707 | -1,400 | -1,050 |
| Issue of Shares | 0 | 0 | 32 | 102 | 0 |
| Inc/(Dec) in Debt | -2,183 | 3,815 | -1,885 | -750 | -1,250 |
| Interest Rec./(Paid) | -22 | 250 | -54 | 376 | 390 |
| Dividends Paid | -892 | -1,189 | -1,598 | -2,062 | -2,572 |
| CF from Fin. Activity | -3,097 | 2,875 | -3,504 | -2,334 | -3,431 |
| Inc/(Dec) in Cash | 1,031 | 4,717 | -1,938 | 2,685 | 990 |
| Add: Beginning Balance | 2,219 | 3,250 | 7,967 | 6,029 | 8,713 |
| Closing Balance | 3,250 | 7,967 | 6,029 | 8,713 | 9,703 |



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Disclosure of Interest Statement

Ashok Leyland

- | | |
|---|----|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with company covered | No |

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