

Industry : Information Technology

CMP : Rs.70

Price Target : Rs.100

Buy

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Current

Recommendation	Buy
CMP (INR)	70.00
Target Price (INR)	100.00

Key Data

Bloomberg code	AFTK@IN
Reuters code	AFTK.BO
BSE code	530707
NSE code	AFTEK
Face Value (INR)	2.0
Market Cap. (INR Mn.)	6124.9
Market Cap. (US \$ mn.)	155.1
52 Week High (INR)	96.3
52 Week low (INR)	45.7

Equity Rs mn	186.9
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Shareholding (30.09.07) Provisional (%)

Promoters	17.3
FII's and Banks	25.6
Bodies Corp.	20.1
Public & Others	37.0
Total	100.0

Returns (%)

	1M	3M	6M	1Yr
Absolute	-4.9	16.3	-6.8	26.5
Rel to Sensex	-4.7	-12.2	-36.0	-9.0

Aftek Ltd, a seasoned player in Software Product Engineering has two decades of experience in the R&D offshore industry. With more than 100 active Intellectual Properties to its credit, Aftek commands premium in its billing rates and increased revenue per employee than most Indian IT companies. The non linear model of the company and its subsidiaries enables the company to beat the 'Rising Rupee' blues most effectively. The company's Sales is expected to grow at a CAGR of 30% from FY07 to FY09. The company is expected to sustain a net margin of 25%+ despite maintaining higher tax. The current price of Rs 70 discounts the FY08E and FY09E EPS by 6.7x and 4.9x respectively. We believe that the company is set to reap substantial benefits out of the painful investments it has made in the last 2-3 years. We recommend a **"BUY"** on the stock with a price target of Rs 100 over the next 12 months, a potential 43% upside over the CMP.

Investment Rationale

- **Stands guarded against rising rupee:** Aftek has negotiated with most of its customers to bill in its contract more than 2% fluctuation in the currency.
- **Umbrella Agreement with ESG,** a German Software provider with a turnover of around 181mn Euros to offshore 30% of its work to Aftek by 2011.
- **Cash rich :** The company's cash reserves is a huge strength for expansion in future. The company's cash on its books stands at Rs 33/share.

Subsidiaries can be a goldmine :

- **Arexera:** Aftek benefits out of Arexera, a 100% subsidiary of Aftek (product – search engine and archiving) in form of royalty revenues to its client BDT, AG. Each product sold by BDT AG will fetch Arexera a royalty of 300 Euros. We have taken a conservative estimate of sale of 7500 units for FY09 to impact our consolidated EPS of Rs 14.40 positively by Rs 1.70.
- **Seekport – Aftek's stake in Seekport may be worth as high as its own market cap. :** Aftek has 25% stake in Seekport. The company has been valued at 475mn Euros on Frankfurt Stock Exchange. Aftek's stake in Seekport would translate its worth at around Rs 6720mn i.e. almost its own market cap. We however, have not built any effect from Seekport into our valuations for Aftek.
- **Digihome (51% stake),** the smart home solutions wing of Aftek is expected to close in almost 4000 flats for its digital solutions in FY09 based on its current order book. We expect Digihome to post sales of Rs 270mn in FY09 at around 10% net margins.

Key Financials (Rs mn)

YE-Mar	Net Sales (Mn)	Growth (%)	EBIDTA (%)	APAT (Mn)	Growth (%)	EPS (Rs)	P/BV	ROCE (%)	P/E
FY06	2586.9	17	41	949.3	37	10.2	1.2	23.1	6.9
FY07	3391.9	31	32	907.4	27	9.4	1.0	19.9	7.5
FY08 (E)	3943.5	16	37	984.2	25	10.5	1.0	22.8	6.7
FY09 (E)	5713.7	45	40	1408.7	25	14.4	0.81	27.5	4.9

E = Estimates

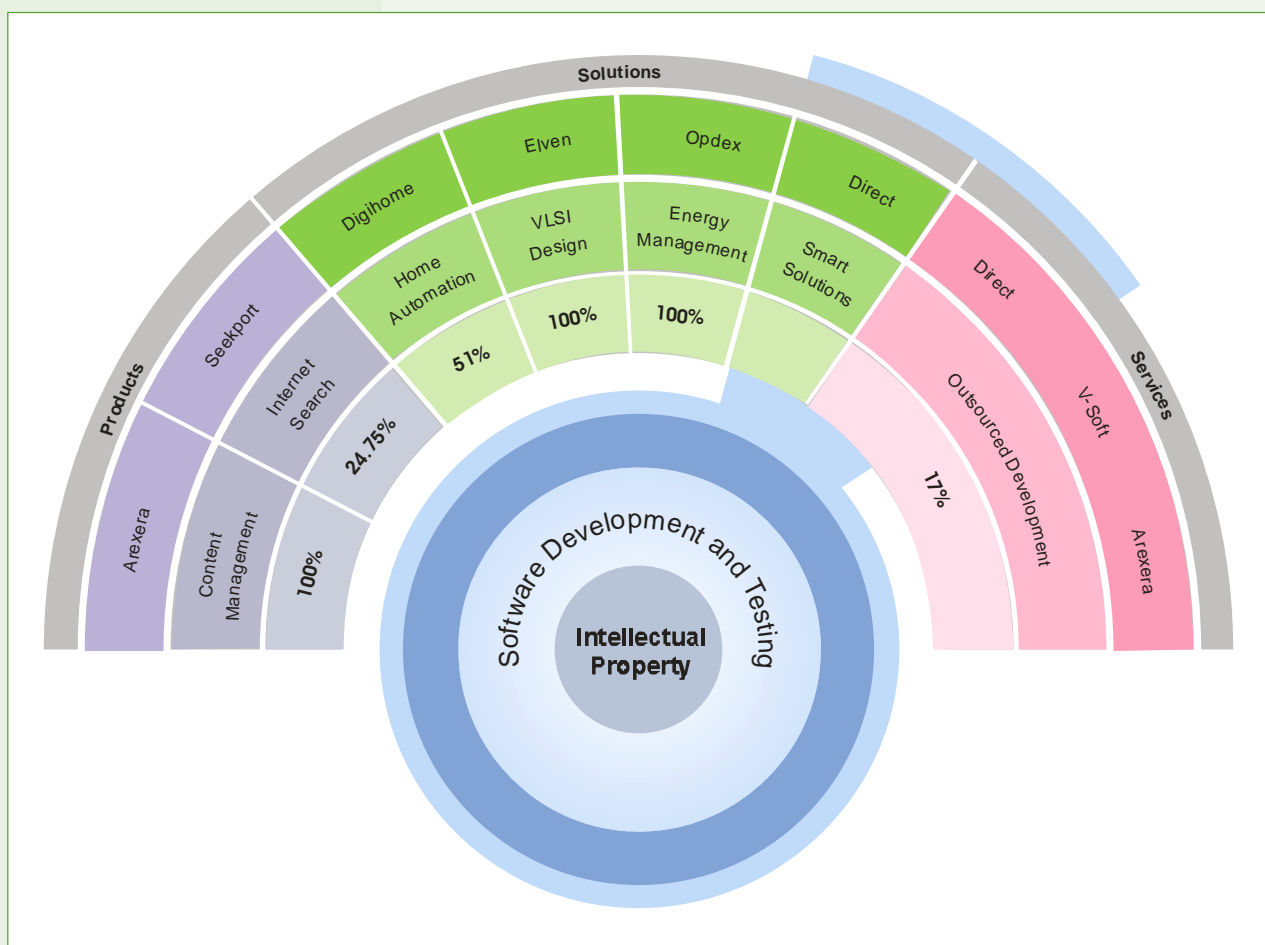
Company profile

Aftek Ltd., a company formed in 1986 is one of the oldest players in the Software Product Engineering in India providing products, solutions and services which span infrastructure, information and process tiers of any modern enterprise. The company has core competencies in the field of communications, whether communication is wired or wireless, short or long distance, networking or telecommunications.

Business Model

The company has meticulously worked out a two-tier model encompassing organic and inorganic growth. At the core of this model are Intellectual Properties (IPs) which have been developed or acquired or enhanced. The development team (of around 700 employees as of Q2FY08) at the organic tier reuses these IPs to provide products, solutions and services to both, the inorganic tier and direct customers. The inorganic tier comprises financial independent companies like Arexera, Seekport, Digihome, Opdex, Elven and V-Soft in which the company has a strategic stake.

Company Structure



Source : Company & Networth Research

IPs held by Companies

Company	Active IPs
Aftek	100
Wipro	90
Tata Elxsi	80
MindTree	60
Sasken	37

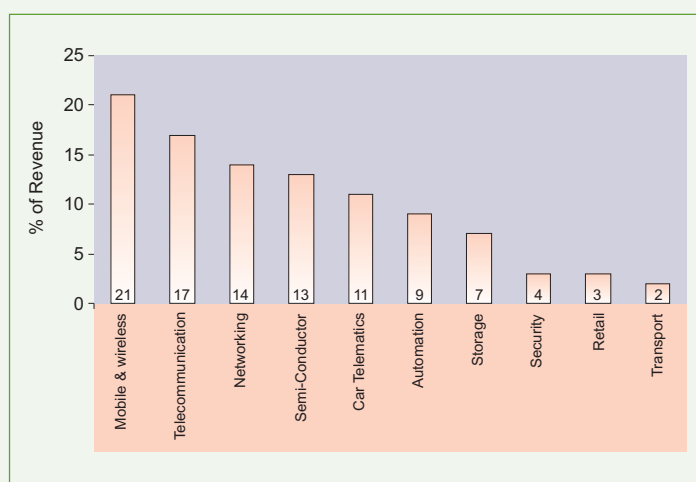
Source : Networth Research

Core business drives the first phase of growth

This deep strength in R&D (IP) differentiates Aftek's business from other Indian R&D outsourcing companies. Unlike most R&D outsourcing companies that derive most of its revenues from per hour cost model, Aftek leverages IPs that it creates and/or buys and enhances them from time to time to reduce time-to-market for its clients, remain highly competitive in pricing and also derive best of ARPP. With a total strength of 700 employees, the company registers more than Rs 3000mn. It also explains the high component of fixed price projects as opposed to Time & Material projects. Aftek has 60% of its projects as Fixed Price Projects.

- Aftek seeks strong business from ESG, a German software solution provider dealing primarily into defense, telematics and aviation. ESG is a pure player (no offshore presence) and has an umbrella agreement with Aftek to offshore 30% of its business (annual turnover in CY06 – Rs 10200mn) to Aftek through Arexera by 2011 starting from Q2FY08. Aftek is also in the process of leveraging its expertise in VLSI to provide solutions to ESG's products. ESG has marquee clients like BMW, Volkswagen, Porsche and Audi. Currently Aftek has deployed roughly 100 dedicated employees for ESG.
- Association with Tensilica (one of the leading IP core makers in the world) fuels the tools for IP development for Aftek, that is the core business of Aftek that could have otherwise cost an upwards of \$5-10mn.
- Aftek derives 40% of revenue from Europe denominated in Euro currency, 5% from Japan and a majority, 55% in dollars.
- Diversified presence in different verticals (auto, aviation, telecom, consumer goods, etc) keeps them safe from a slowdown in any particular industry.
- Marquee clients like BMW, Broadcom, ESG, etc. acts as important reference points for cross selling as well as new clients.

Vertical Distribution and Marquee Clients



Source : Company & Networth Research

Mining through the Subsidiaries

Arexera

Aftek may be classified in the league of product centric companies with Arexera's product contributing long term and sustainable royalty revenues from FY09 onwards.

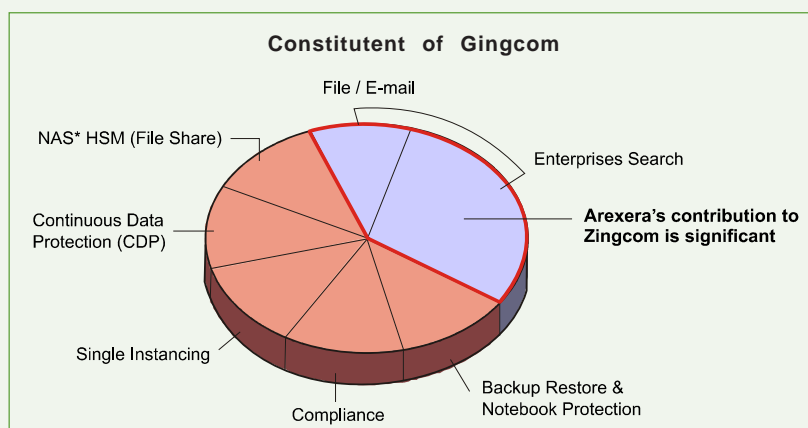
Arexera has entered into a strategic tie up with BDT AG, of Germany, world leaders in data storage systems. Under the terms of the tie up, Arexera will license its state-of-the-art search and archiving technology for BDT's new data storage device 'Gingcom Appliance'. For each appliance sold by BDT, Arexera will be entitled for a royalty payment of about 300 Euros if the volumes sold will be under 10000. Beyond 10000 units sold, BDT will pay royalty of 250 Euros. We estimate sales of 7500 units of Gingcom appliances in FY09 starting from Q2FY09 through BDT's own network as well as its OEM partners, during a full year of operation.

Arexera's scope of business

Target Market	Competitors	USP	Distribution through	Cost of the Product	Limitation	Expected to sell in FY09	Likely effect on EPS in FY09
SMEs in Europe and America	IBM, EMC targetted towards large enterprises and fragmented market for SMEs	Integrated Solution for storage, archival, retrieval and compliance (almost 70 diff standards)	OEMs like Hitachi, HP, Dell and Retail sale	25000 - 40000 Euros	Compatible with Microsoft Environment only.	7500 units	Rs 1.6

Source : Networth Research

We have estimated the royalty revenues generated out of proceeds from BDT at around Rs 220 mn in FY09 and expected to grow by 150% in FY10. Interestingly, with minimal operating costs involved, most of this revenue trickles down to PBT. The company derives tax benefits being registered out of Switzerland and will bear 7% tax on PBT. We believe that this continuous stream of profits through its product sale will bring windfall gain to the company's fortunes from FY10 onwards.



Source : Networth Research

Digihome

Digihome, a 51% subsidiary of Aftek is a clear example of how investments in IPs results into significant opportunities in the long term. Resultant out of its erstwhile IP on infrastructure, Jadoogar, Digihome has evolved the concept of a smart home that gives complete digital home solutions.

Digihome scope of business

Target Market	Competitors	USP	Distribution through	Cost of the Product	Limitation	Expected to sell in FY09	Likely effect on EPS in FY09
Premium New Households - Retail and Commercial	Honeywell, Clippsons, Zicom	High integration of information, security, Communication and entertainment over a single cable on the Internet protocol.	B+ grade builders in Pune, Hyd, Blore and Mum	35000-upwards of 1.5 lakhs	needs to beef up the sales staff, yet to break into the A-league builders. Long sales cycle.	plans to cover up around 5000-6000 flats	Negligible in FY09 but gears up in FY10

Source : Networth Research

We believe the underlying value in this business may be immense if marketed properly.

It is estimated that India will have 5.1 mn new homes by 2010 growing at 2.4% CAGR from FY05. Reports suggest that almost 1.2 mn new homes will be premium houses. We expect the company to capture 0.5% of the new construction in India. The company has already installed its products in establishments of leading builders like Rohan Builders (Pune), Kumar Builders, Godrej, etc and is in lead talks with Mantri, (Bangalore), Maytas (Hyderabad) and others. However, we believe that there will be two trigger points that may position Digihome into a different orbit.

- The company has to break into the A-league builders like Unitech, DLF, etc. or large housing society that may open room for several thousand flats.
- The opportunity in retrofit projects i.e existing premium homes at around 64mn homes is atleast 10 times bigger than the new ones. The company currently operates in new construction only. However, it is developing a solution for existing homes too that may be released in 2010.

We have estimated Digihome to start contributing from Q3FY09 with revenues booked only on full realization. We've estimated Aftek's stake in Digihome at revenues of Rs 140mn and it contributes Rs 13.6mn to PAT in FY09. However, with the growing acceptance of the product, it is expected to grow substantially in FY10 to around Rs 1300mn at 25% net margin. Digihome enjoys tax benefits (no tax) until FY12 and excise benefits forever as its manufacturing facility is in Solan (excise free zone and tax-free until FY12).

Seekport

Seekport is a regional European white-label sponsored links software company where Aftek has 24.75% stake through Arexera. Search is the second most used application on internet after e-mail. Although search functionality by itself is free, search engines make money by selling sponsored links as a form of online advertisements. Out of all forms of online advertisements like banners, sponsorships, etc, sponsored links contribute to nearly 40% of the revenues. Aftek has significant commitment to search space in terms of Arexera and Seekport. A major portion of Seekport's revenues (close to 40%) is derived out of licensing its search (ad sense) to portals that derive its revenues from ad clicks.

Seekport's search is regional and has a strong presence in Europe and Middle East. It has been recently listed on the Frankfurt Stock Exchange at 4.75 Euros per share with the total market cap at 475mn Euros (Rs 26,500mn). We have done a bear-base-best case analysis to gauge the impact on Aftek at different valuations:

Sensitivity Analysis on Arexera's benefit out of Seekport

	Best	Base	Bear
Seekport Per share Price (Euro)	4.75	3.75	2.75
Mcap (mn Euros)	475	375	275
Mcap (Rs mn)	26600	21000	15400
Discount, 20% on Investments	21280	16800	12320
Aftek's share @ 24.75% (Rs mn)	5266.8	4158	3049.2
No. of shares (mn)	93.45	93.45	93.45
Additional per share Value to Aftek (Rs)	56	44	33

Source : Company & Networth Research

Hence, even under our bear case scenario, the investments in Seekport may yield Rs.33 for each share. It is unclear right now, when will the investments be converted by Aftek or when will the liquidity be infused. We therefore would wait and watch until there is some liquidity on the stock. There may be liquidity infusion by means of an IPO floated next year.

Peer Comparison

	CMP (Rs)	(Rs bn)	Sales (Rs bn)			Net margins (%)			P/E			P/BV	ROCE (%)	
		Mcap	FY07A	FY08E	FY09E	FY07A	FY08E	FY09E	FY07A	FY08E	FY09E	FY07	FY08E	FY09E
Aftek	70	6.2	3.39	3.94	5.71	26.7%	25.0%	24.7%	7.5	6.7	4.9	1.0	22.8%	27.5%
Sasken	272	7.75	4.77	6.22	7.43	9.5%	5.9%	9.4%	17.0	20.8	10.6	1.8	7.1%	12.4%
Tata Elxsi	244	7.41	3.08	4.36	6.05	17.0%	12.9%	13.5%	14.9	13.3	9.2	8.4	51.7%	54.1%
Geometric	73	4.50	3.83	5.16	6.86	9.8%	8.6%	8.5%	11.7	10.2	7.9	2.0	11.7	18.1
Mindtree	423	15.95	5.90	7.41	9.82	15.3%	13.5%	12.9%	14.6	16.8	13.1	3.7	15.1	17.4
KPIT	101	7.74	3.16	6.14	8.04	14.5%	10.3%	10.8%	14.8	12.7	9.4	3.0	15.9	17.6

(Source : Company & Bloomberg estimates)

Financial Outlook

Aftek's revenue is expected to grow at a CAGR of 30% from FY07 to FY09. The net profit is expected to surge by a CAGR of 25% over the same period. Aftek registering higher than industry growth is a point of proof that niche service / product offerings will command a premium.

- The EBIT margin of the company is estimated to remain stable at around 28% for the next two years despite higher depreciation on IP. The company writes off all its IPs over 3 years.
- Aftek has been operating out of SEZs so far and therefore had ETR at 1% of PBT. However going forward, we observe MAT applicable that will increase tax rates to 8% and 11% of PBT in FY08 and FY09 respectively. The other income figures are shown net off taxes and hence included in the tax structure.

We believe the following points make it a compelling recommendation for a BUY :

- With respect to strong financials, Aftek is one of the most undervalued stock when compared to its peers. It trades at a discount of almost 50% to its nearest comparable peer.
- The company's investments into its subsidiaries, Arexera, Seekport and Digihome transform the company into the league of royalty bearing product companies.
- The fierce risk of a fluctuating currency is mitigated by its well diversified geography and contract with its customers to adjust 2% fluctuation.
- Aftek has had a strong record of paying dividends, at 50% of its FV each year in the last 5 years.

Valuations

At the current market price of Rs 70, the stock is trading at a P/E of 6.7x and 4.9x its FY08E and FY09E EPS respectively. Despite strong fundamentals, the company is valued at 50% discount to its nearest competitor. Owing to its reclassification as a product company, we believe that the stock is a strong candidate for re-rating from its existing average forward P/E of 6.5x - 8x. We have however, been extremely conservative in our approach for projections. The company's cash reserves is a huge strength for expansion in future. The company's cash on its books stands at Rs 33/share. At a P/BV of 1.0, the stock is extensively undervalued. We have valued the company at mere 7x its FY09E EPS of Rs 14.4 and firmly recommend a **BUY** with a price target of Rs 100, an upside of 43% over the CMP.

Concerns

- **Low promoter holding:** The promoter holding stands at 17.3% in the company. Promoters have increased their stake from 12.2% in the last quarter to 17.3% in this quarter due to the merger of one of its subsidiaries, Elven. However, it is still at an uncomfortable level.
- The **company's image** has been tarnished having been entangled in a case earlier (2000-01) with SEBI. The promoters have however been given a clean chit by SEBI last year. We remain cautiously optimistic on the management going forward.
- **Series of new business to start in FY09 onwards:** The company is monetizing from a host of new commercial ventures. It must be constantly monitored to gauge the progress of treading on uncharted territories. We have been conservative in our projections to that effect.
- The company has unutilized cash reserves of Rs3000mn mostly parked overseas, yielding low interest (1-2%). The company had primarily used it for paying off overseas expenses. However, off late, the company has started bringing it back putting it in worthwhile investments.

PE Band



Profit & Loss

YE-March	(Rs. mn)			
Income Statement	FY06A	FY07A	FY08E	FY09E
Sales Services (%)				29.8
Standalone+ Elven	2586.9	3391.9	3943.5	4954.6
Products				
Arexera	-	-	-	618.8
Digihome	-	-	-	140.3
Sales Total	2586.9	3391.9	3943.5	5713.7
Salaries and Wages	132.5	252.2	260.6	921.2
Testing, Consultation	1182.3	1882.3	2097.0	2622.0
Other Expenditure	212.5	188.5	143.9	196.2
Operating Profit	1059.5	1069.0	1442.0	1974.3
OPM (%)	41.0	32.0	36.6	39.8
Interest	-	-	-	-
Depreciation	177.9	148.6	336	358
Other Income	-	66.7	38.0	40.0
PBT	959.8	920.3	1068.6	1576.7
Provn for Tax	10.4	13.0	84.4	168.0
% of PBT	1.1	1.0	7.9	10.7
Net Profit	949.3	907.4	984.2	1408.7

Cash Flow Statement

	(Rs. mn)			
Cash Flow from Operating Activities	FY06A	FY07A	FY08E	FY09E
A. Cash Flow from operating Activities				
PBT	685.2	920.3	1068.6	2464.2
Depreciation and Amortization	135.1	148.6	335.6	357.6
Interest Income	(28.7)	(61.8)	(40.0)	(40.0)
Misc Exp written off	5.3	6.8	-	-
Unrealised Foreign Exchange Loss	(49.3)	92.9	(118.1)	(100.0)
Operating profit before Working Capital changes	755.7	1110.7	1364.2	2781.71
Decrease / (Increase) in S. Drs	(399.5)	(1.6)	(128.8)	(728.2)
Decrease / (Increase) in Loans /Advances	0.0	(172.4)	(64.9)	(198.4)
Increase / (Decrease) in Current liabilities	141.5	-	175.6	281.1
Cash Inflow from operations	497.9	937.0	1338.8	2143.6
Income Tax Paid	(8.6)	(13.2)	(84.4)	(386.9)
Net Cash Inflow from Operating Activities	489.3	928.7	1262.3	1749.2
Purchase of fixed Assets / Capital Advances	(21.3)	(1001.5)	(776.0)	(1156.8)
Acquisition of shares from promoters	(548.2)	0.5	-	-
Investment in others	(41.0)	(1.1)	(198.6)	(966.0)
Sale of fixed projects	0.7	0.1	-	-
(Increase) / Decrease in Loans & advances to others	(18.6)	(197.1)	(64.9)	(198.4)
Advances from Acquisitions	(20.0)	0.5	-	-
Interest received from MF Income	34.5	70.3	114.0	(75.0)
Net cash outflow from investing activities	(613.9)	(1128.8)	(933.0)	(2388.7)
C. Cash Flows from financing activities				
Issue of FCCB	194.1	-	-	-
FCCB Expenses	(19.3)	-	-	-
Interest paid	(5.8)	(9)	(8)	-
Dividend paid (Incl Tax on Div)	(96.0)	(101)	(117)	(152)
Net cash outflow from financing activity	78.0	10.7	(125)	(152)
Net increase/ (decrease) in cash and cash equival	(46.5)	(189.4)	196.5	(784.2)
Cash and Equivalents at the beginning of year	3234.4	3280.9	3091.5	3288.0
Cash at the end of the year	3280.9	2990.0	3201.9	2402.8
Cash & Equivalents at the beginning of period	3281.1	3356.0	2992	3188.5
Cash acquired on acquisition	0.8			
Cash & Equivalents at the end of the period	3281.7	6447.5	3188.5	2404.3

Balance Sheet

YE-March	(Rs. mn)			
	FY06A	FY07A	FY008E	FY09E
Sources of Funds				
Equity Capital	171.4	174.5	186.9	195.4
Warrants outstanding	47.9	-	-	-
Reserves and Surplus	4632.2	5754.1	6621.3	8144.8
Networth	4851.5	5928.6	6808.2	8340.1
Total Debts	528.6	395.9	209.0	-
Capital Employed	5380.1	6324.5	7017.7	8340.1
Fixed Asset	158.3	990.6	1275.4	1784.8
Gross Block	642.3	1455.7	1932.7	2249.5
Less :- Accumulated Depreciation	498.4	633.0	956.3	1303.7
Net Block	143.9	822.7	975.4	945.8
Capital Work in Progress	14.3	187.6	300.0	839.0
Investment	1186.0	1185.4	1384.0	2350.0
Inventories	1.9	2.1	2.0	2.0
Debtors	855.5	857.1	985.9	1714.1
Loans & Advances	325.1	496.5	561.4	759.9
Cash Balances	3309.4	3010.1	3201.9	2402.8
Curr Assets, Loans & Adv	4492.4	4345.8	4751.2	4878.8
Curr Liab & Prov	465.3	218.7	394.3	675.4
Net Current Assets Block	4027.1	4127.1	4356.9	4203.4
Misc Expenses	9.3	1.7	2.0	2.0
TOTAL	5380.7	6324.5	7017.6	8340.1

Ratios

	FY06A	FY07A	FY08E	FY9E
Growth				
Net Sales (%)	17.2	31.1	16.3	44.9
Adjusted Net Profit (%)	12.8	-4.4	8.5	43.1
EBITDA (%0	2.6	0.9	34.9	36.9
EPS (%)	-7.9	11.7	11.5	47.5
Gross Fixed Assets (%)	2.9	126.6	32.7	34.0
Capital Employed (%)	17.1	17.6	13.6	17.5
Valuation				
EPS (Rs.)	10.2	9.4	10.5	14.4
CEPS (Rs.)	13.8	12.2	14.1	18.9
BVPS (Rs)	56.6	67.9	72.8	86.4
PER (x)	6.9	7.5	6.7	4.9
PEG (x)	-	(0.9)	0.6	0.1
P/CEPS (x)	5.1	5.7	5.0	3.7
P/BV (x)	1.2	1.0	1.0	0.81
EV/EBITDA (x)	6.9	5.1	3.7	2.0
EV/Net Sales (x)	1.4	1.1	0.8	0.7
Profitability				
ROCE (%)	23.1	19.9	22.8	27.8
ROE (%)	19.6	15.3	14.5	16.7
EBIDTA Margin (%)	41.0	31.5	36.6	39.8
Net Profit Margin (%)	36.7	26.7	25.0	24.7
Tax incidence - Tax/PBT (%)	1.0	1.3	8.0	10.7
Revenue per Employee	5.7	6.5	5.4	4.8
Profit Per Employee	2.1	1.7	1.4	1.2
Turnover				
Avg. Collection Period (Days)	121	92	91	110
Market Capitalisation	6,000.2	6,108.6	6,542.3	6542.3
Enterprise Value	3219.4	3494.3	3557.0	4038.4

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Research	Sector	E-mail id	Telephone nos.
Huzaifa Suratwala	Auto / Banks / Shipping / Logistics	huzaifa.s@nsbl.co.in	022-30286389
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Rajan Kumar	Cement / Pharmaceuticals	rajan@nsbl.co.in	022-30286389
Rati Pandit	Hotels / Aviation	rati@nsbl.co.in	022-30286389
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