

Coverage Stock: Parag Milk Foods Ltd

Value added player; FMCG in making

CMP INR 225 Target INR 300

Rating: BUY Upside: 33%

Parag is the dominant player in the value-added milk segment with milk processing capacity of 2 mn litres per day. Over the years, the company has successfully created a strong brand portfolio and is consistently innovating and introducing new products in the market. It is the sole integrated dairy player across the value chain from dairy farming, to milk procurement, processing, distribution as well as branding, lending it an inherent benefit of secure and steady raw material supply along with enhanced reach on branding & distribution. We believe, Parag, being an integrated dairy player with focus on value-added dairy products, is in a unique position to reap dual benefits of a dairy company coupled with a FMCG play in the long run. Parag is likely to trade at premium valuations akin to FMCG players. Currently, the stock is trading at 23.5x FY19E earnings. We initiate with 'BUY' and price target of Rs 300, assigning 31x PER for FY19E EPS of Rs 9.6.

Largest private value-added player with vibrant product portfolio: Parag is a dominant player in the value-added business with cheese, ghee, flavoured milk, etc., contributing around 65-67% to revenue from 53% in FY14. These categories, growing in strong double digits (20-25%), present robust opportunity for Parag to cash in on. Moreover, the company boasts of a diversified product portfolio with 140 plus SKUs spread across 7 brands—Gowardhan, Go, Pride of Cows, Avvatar, Slurp, Milkrich and Topp up. On the distribution front, it has 17 depots, 140 super stockists and over 3,000 distributors. Its products are also available across all modern retail stores.

Sole integrated player; innovative offerings, premiumisation strategy to boost realisation: Parag is the only dairy player which is integrated across the value chain from dairy farming to milk procurement, processing, distribution as well as branding. Thus, we believe, the company has an inherent benefit of secure and steady raw material supply along with enhanced reach on branding & distribution. Also, in order to maintain interest of existing consumers and to tap additional consumers, Parag has steadily introduced multiple new products. It also entered new segments in FY17 with Avvatar (whey protein) and Slurp (mango beverage with a dash of milk). In the long term, we believe this strategy will provide it an edge over other dairy players, which are focusing only on fresh milk products. Apart from expanding its cheese portfolio, the company is also developing premiumisation strategy for its cheese products. As consumer preferences evolve, the company will be able to cater to a larger set of consumers as well as improve realization & margins

Strong proxy for changing consumption patterns; initiate with 'BUY' and price target of INR 300: Parag, being an integrated dairy player with focus on value-added dairy products, is in a unique position to reap dual benefits of a dairy company coupled with a FMCG play in the long run. The company has moved up the value chain in terms of product portfolio, which is likely to improve already stellar gross margin. Given the strong structural tailwinds, coupled with sharpening focus on branding, communication and reach along with a bouquet of innovative products, Parag is likely to trade at premium valuations akin to FMCG players. Hence, we assign PER of 31x to FY19E EPS of Rs 9.6 to arrive at our price target of Rs 300. We initiate coverage with 'BUY'.

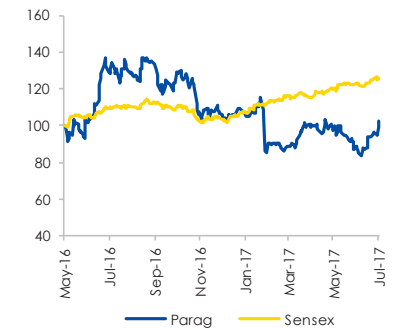
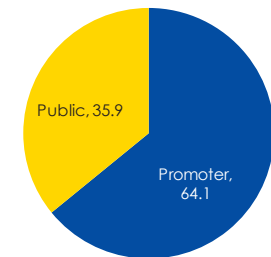
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Bloomberg:	PARAG: IN
52-week range (INR):	355 / 202
Share in issue (cr):	8.41
M cap (INR cr):	1,895
Avg. Daily Vol.	361
BSE/NSE :('000):	



Date: 10th August 2017

Year to March (Consol) (INR cr)	FY16	FY17	FY18E	FY19E	FY20E
Revenues (INR Cr)	1,645	1,731	2,011	2,290	2,621
Rev growth (%)	13.9%	5.2%	16.2%	13.9%	14.5%
EBITDA (INR Cr)	148.2	108.1	181.3	228.6	267.1
Adjusted Net Profit (INR Cr)	47.8	36.5	56.3	80.6	99.6
EPS (INR Cr)	5.7	4.3	6.7	9.6	11.8
EPS growth (%)	48.5	-23.7	54.2	43.1	23.6
P/E (x)	39.5	51.8	33.6	23.5	19.0
P/B (x)	5.2	2.9	2.7	2.4	2.1
RoACE (%)	17.4	7.1	13.0	15.4	16.6
RoAE (%)	8.7	3.7	5.4	7.2	8.2

Parag being a focused player with strong product portfolio in the value added dairy space is likely to reap dual benefit of transition towards organized, along with the changing consumption trends in the dairy industry. Company's end to end integration, coupled with focus on branding and distribution is likely result in 40% earnings CAGR over FY17-20E

Opportunities galore for branded & packaged dairy player- Mammoth industry at INR 6 lac crore, of which only 20% is organized.

	FY16	FY17	FY18E	FY19E
Revenue	1645	1731	2011	2290
EBITDA	148	108	181	229
EBITDA Margin	9.0	6.2	9.0	10.0
Adjusted PAT	48	37	56	81

Innovative product portfolio, moving towards premiumization, focused branding, enviable distribution set-up to result in strong margin improvement from the current level.

	FY16	FY17	FY18E	FY19E
RoACE (%)	17.4	7.1	13.0	15.4
Debt to Equity (x)	1.0	0.4	0.4	0.4

Owing to the high scalability of the busies, enhanced stickiness of customers, we expect Parag to trade at premium valuation to peers akin to FMCG

	Multiple	Price Target
Parag	31xP/E	300

Entry = INR 225



PAT CAGR of 40% over FY17-FY19E to lead to exit multiple of 31x FY19E P/E

Total Return of 33%

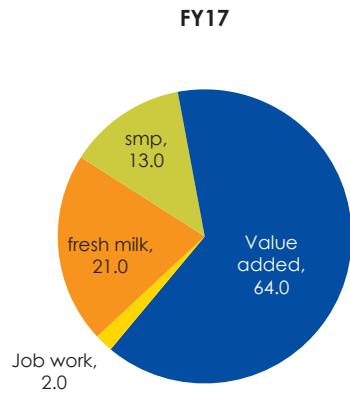
Price Target	INR 300	We have estimated Parag's gross margin to improve to 30.1% by FY19 from 27.3% in FY17, leading to 280 bps margin expansion. This will be led by stable milk prices and rising share of premium products in its portfolio. Thus, we expect EBITDA margin to clock a sharper 370 bps improvement to 10% in FY19E from a low of 6.2% in FY17, resulting in healthy 48.5% earnings CAGR over FY17-19E. We assign 31x FY19E to arrive at price target of INR 300
Bull 36x Bull Case FY19E EPS	INR 416	On a blue sky estimate, the company's EBITDA margin is expected to improve from the current 6.2% to 10.5%, resulting in PAT margin of 4% in FY19. This is expected to lead to PAT of INR 100 for FY19E. Assigning 35x FY19E, we arrive at a bull case price target of INR 416.
Base 31x Base Case FY19E EPS	INR 300	We have estimated Parag's gross margin to improve to 30.1% by FY19 from 27.3% in FY17, leading to 280 bps margin expansion. This will be led by stable milk prices and rising share of premium products in its portfolio. Thus, we expect EBITDA margin to clock a sharper 370 bps improvement to 10% in FY19E from a low of 6.2% in FY17, resulting in healthy 48.5% earnings CAGR over FY17-19E. We assign 31x FY19E to arrive at price target of INR 300.
Bear 25x Bear Case FY19E bearish EPS	INR 205	Challenges in procurement and stickiness of higher milk prices, along with the company's inability to pass on the same to consumers will have repercussion on margin and profitability— we estimate 7.5% EBITDA margin and 3% net margin for FY19 (PAT being inr 69 crore). We assign 25x FY19E PER to arrive at price target of INR 205.

Average Daily Turnover (INR cr)			Stock Price (CAGR)				Relative to Sensex, CAGR (%)			
3 months	6 months	1 year	1 year	3 years	5 years	10 years	1 year	3 years	5 years	10 years
1.7	1.6	1.5	-32	-	-	-	-	-	-	-

Business Value Drivers	Nature of Industry	One of the key industries with large base of suppliers and consumers. The industry is largely regional with cooperatives enjoying advantageous position owing to their development and non-profit nature. Amul is the largest organised player.
	Opportunity Size	The Indian dairy industry is pegged at INR 6 lac crore, of which ~80% is unorganised and only 20% is organised. 90% consumption is in the traditional form of liquid milk, ghee, paneer and curd. New value-added categories like cheese, butter milk, butter, flavoured milk and whey protein are growing 2-3x the overall industry and present strong opportunity.
	Capital Allocation	Parag has, over the past 18-24 months, undertaken capex to enhance its back end as well as distribution capability. Benefits of these are likely to reflect in the financials going ahead in terms of improved revenue and enhanced margin
	Predictability	We believe, anchored by healthy product portfolio, increasing innovation and a vigorous management, Parag is poised to deliver strong earnings
	Sustainability	Dairy is a consumer-led business, which requires continuous innovation in taste and consistency in quality. Hence, sustainability depends on distribution footprint along with quality and innovative products. .
	Disproportionate Future	Transition of Indian consumers from unorganised to organised players, along with favourable demographics and rising health consciousness bode well for a player like Parag
	Business Strategy & Planned Initiatives	Parag's target is to become a formidable player in the value-added dairy segment encompassing the benefit of dairy integration along with the asset light structure of a FMCG company. Going forward the company would undertake measured capex and improve returns
	Near Term Visibility	Strong visibility of 40% bottom line CAGR along with improvement in operating margin over FY17-20E.
	Long Term Visibility	Indian consumers are moving towards branded & packaged food and dairy is a strong daily consumption requirement. Rising health awareness and dwindling clout of co-operatives are likely to benefit organised players

Focus Charts – Story in a nutshell

Parag- a milk product play

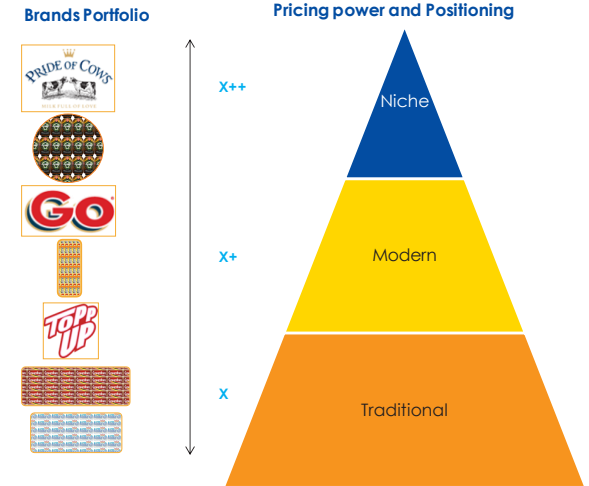


Integrated play with presence across the category makes Parag unique

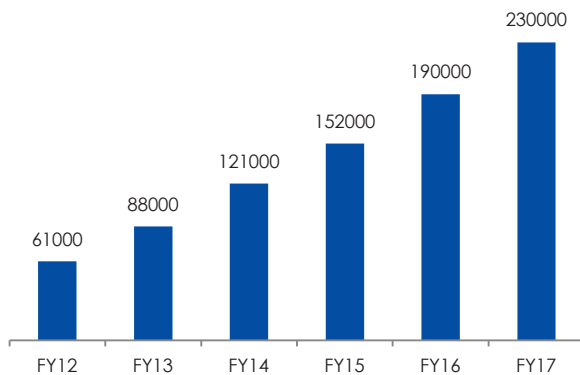
	Procurement	Processing	Brands	Value added B2C	Pan India distribution
Hatsun	●	●	Arun	25	●
Heritage	●	●	Heritage	22	●
Prabhat	●	●	Prabhat	10	●
Parag	●	●	Go, Gowardhan, Toppup, Pride of Cows, Avvatar, Slurp, Milk rich	65	●
Kwality	●	●	Kwality, Dairy best	0	●
Britannia	●	●	Britannia	100	●
Nestle	●	●	Nestle	100	●
Dannone	●	●	Dannoe	100	●

Legend: ● Yes, ● NO, ● Marginally

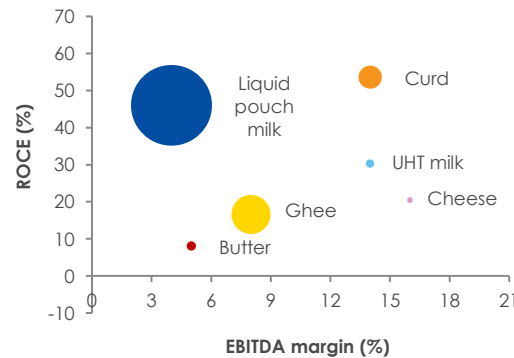
Strong & Innovative product portfolio makes it akin to FMCG



Increasing retail touch points (nos)

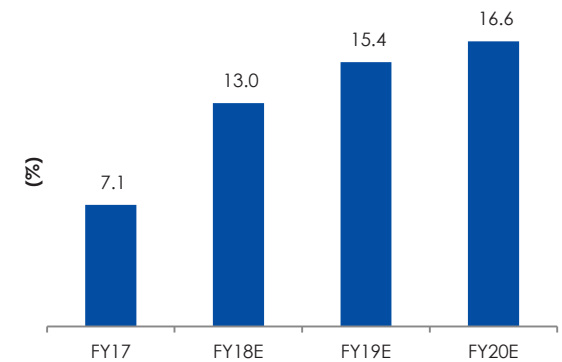


Value added products fetch higher margins; and Parag scores high on value addition



Size of the bubble denotes the category size

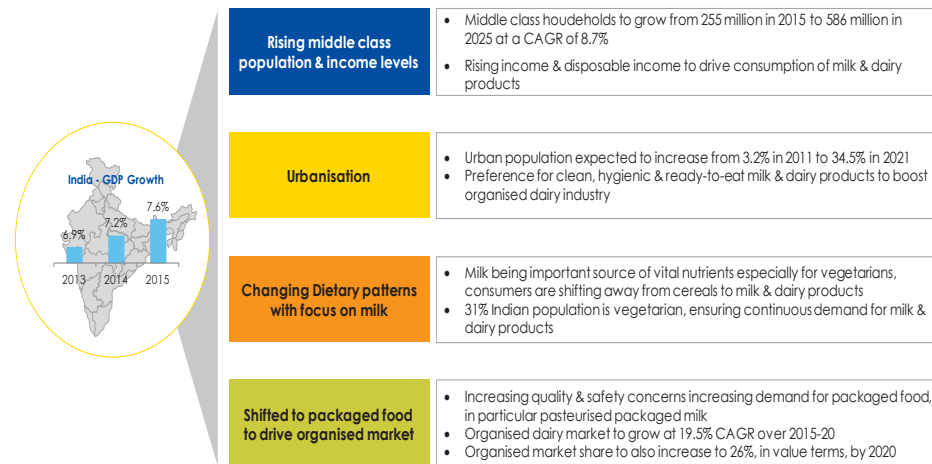
ROCE to improve ahead



Source: Company, Edelweiss Investment Research

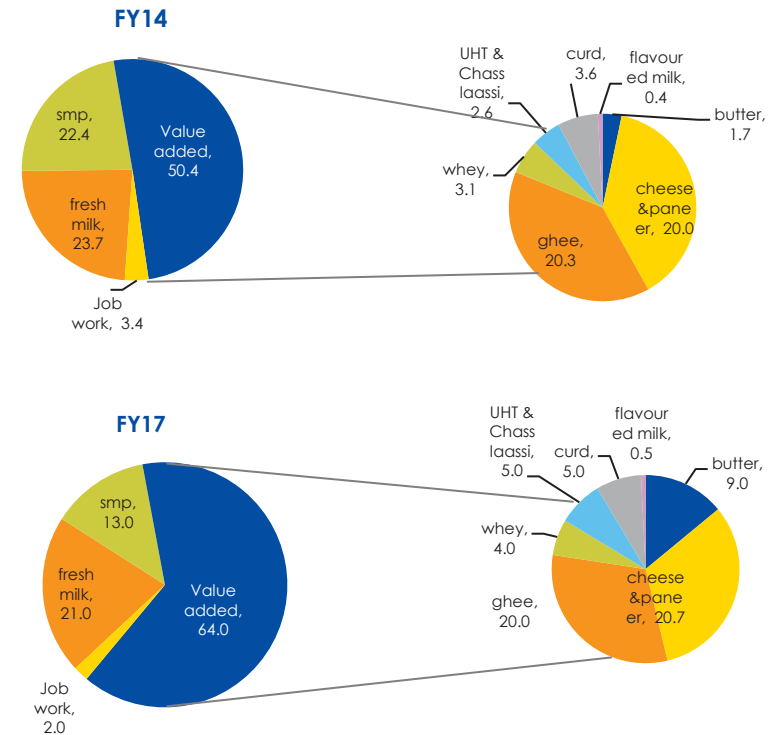
I. Key Investment positives

Changing consumption patterns & Parag's dominance in milk products places it in the sweet spot

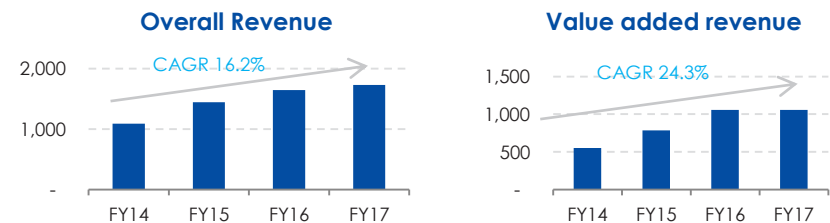


In the organised pie, growth is envisaged to be broad based, with value-added segments spearheading robust surge, penetration of which is still in single digits. Also, certain westernised categories like cheese, whey protein, yogurt, flavoured milk, etc., which were not part of Indian cuisine earlier, are incrementally finding favour in the youth food segment. Hence, they are estimated to clock a robust 25-30% CAGR over FY17-19.

Parag is the dominant player in the value-added business with cheese, ghee, flavoured milk, etc., contributing around 65-67% to revenue from 53% in FY14. These categories, growing in strong double digit (25-30%), present strong opportunity for Parag to cash in on.



The value-added category in the company's portfolio has posted a robust 24.3% CAGR over FY14-17, surpassing the company's overall growth of 16.2%.



Source: Company, Edelweiss Investment Research

II. Integrated player from procurement to branding: Unique model

The domestic dairy industry is polarised. On one hand, there are players which are strong in procurement leveraging their relationships with farmers, giving them access to a steady supply of fresh milk. On the other, there are players with strong brands and distribution reach, but sans sourcing or procurement arrangement, restricting them on the freshness and quality aspect.

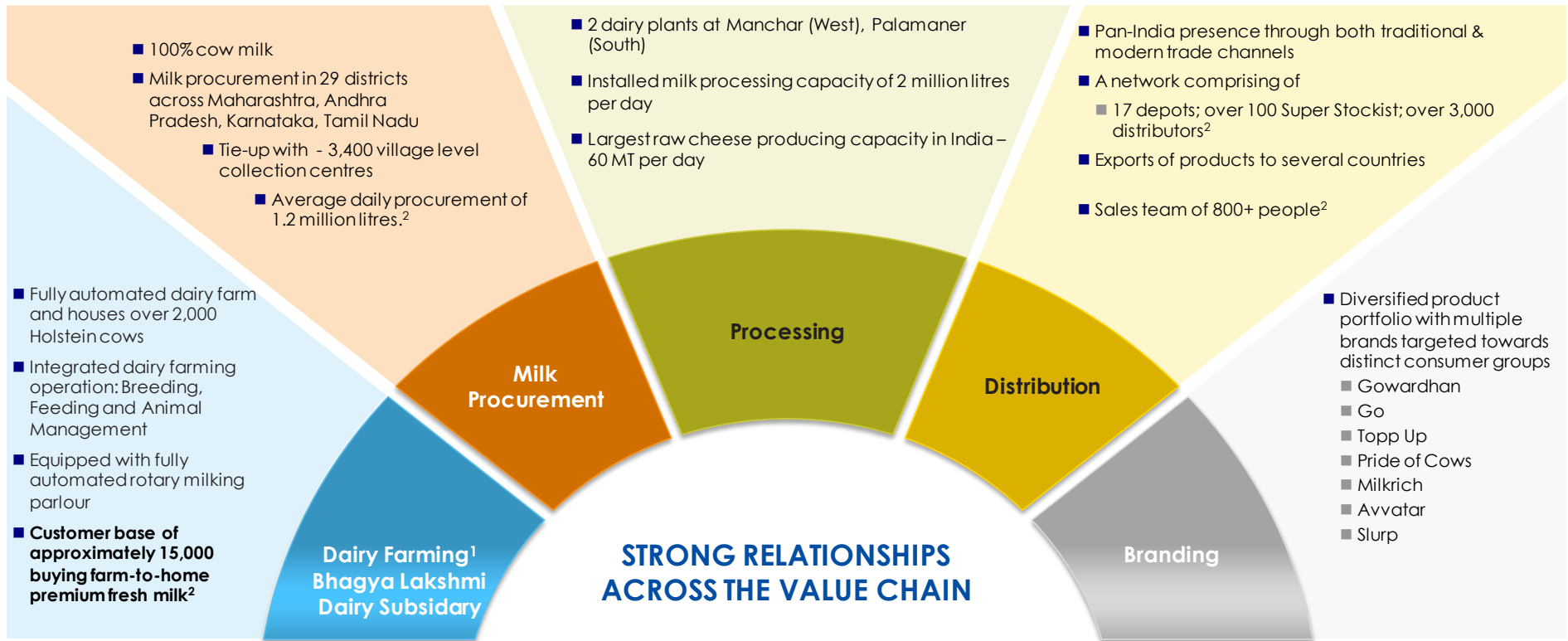
Parag is the sole dairy player which is integrated across the value chain from dairy farming, to milk procurement, processing, distribution as well as branding. Thus, we believe, the company has an inherent benefit of secure and steady raw material supply along with enhanced reach on branding & distribution.

Parag presence across the vertical makes it an integrated play

	Procurement	Processing	Brands	Value added B2C	Pan India distribution
Hatsun	●	●	Arun	25	●
Heritage	●	●	Heritage	22	●
Prabhat	●	●	Prabhat	10	●
Parag	●	●	Go, Gowardhan, Toppup, Pride of Cows, Avvatar, Slurp, Milk rich	65	●
Kwality	●	●	Kwality, Dairy best	0	●
Britannia	●	●	Britannia	100	●
Nestle	●	●	Nestle	100	●
Dannone	●	●	Dannoe	100	●

● Yes ● NO ● Marginally

Parag- Integrated branded dairy play from procurement to distribution makes it agile & akin to FMCG play



III. Innovative product portfolio with smart segmentation differentiates Parag from other milk plays

Parag has developed a complete portfolio of value-added milk products including ghee, buttermilk, dahi (yogurt), lassi, flavoured milk, cheese, dairy whitener and whey protein. The company has also entered the whey protein segment under brand- "Avvatar" and introduced a fruit beverages under the "Slurp" brand.

Sub-segmentation strategy across products: Parag has steadily developed a portfolio of products around its core brands. After introducing cheese, it has launched a slew of cheese variants. After introducing yogurt, it has introduced fruit-flavoured yogurt. In order to attract South Indian consumers, it has introduced buttermilk with southern spices, apart from introducing regular buttermilk. The company has also introduced multiple variants of milk. This strategy is expected to differentiate it among peers and help attract and retain consumers.

Steady flow of product launches

In order to maintain interest of existing consumers and also to tap additional consumers, Parag has steadily introduced multiple new products. In its endeavour to delight the customers and bring innovation, it introduces 3-4 differentiated products every year. The company also entered new segments in FY17 with the launch of *Avvatar* (whey protein) and *Slurp* (mango beverage with a dash of milk). We reckon that the company is investing in segments such as cheese and whey protein where consumers do not have the ability to prepare these products at home. In the long term, we believe this strategy will provide an edge to Parag over other dairy players, which are focusing only on fresh milk products.

Premiumisation strategy: Apart from expanding its cheese portfolio, Parag is also developing premiumisation strategy for its cheese products. Most products are priced at a premium to the base cheese product range. As consumer preferences evolve, the company will be able to cater to a larger set of consumers as well as improve realisation & margins.

Pioneering Product Innovation With Strong R&D Thrust



Premium quality cow milk - "farm-to-home" concept through Subscription model



Go "Cheezooz" awarded the "Best Children's Dairy Product" in the product innovation category



Wide & innovative variety of cheese including gourmet cheese, jalapeno cheese spread, herb cheese cubes



Pioneering and Leading player in India to market fresh paneer in retail stores with a shelf life of 75 days



Avvatar – India's first company to launch a sports nutrition protein powder

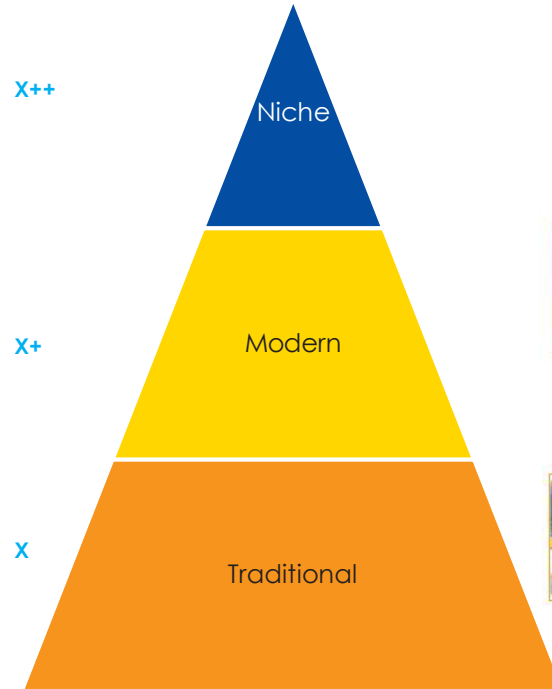
2013	2014	2015	2016	2017
<ul style="list-style-type: none"> • Emmental cheese • Consumer packs of mozzarella cheese • Yogurt in three new flavours of saffron, pink guava and vanilla • Topp-up in four flavours • Cheese spread in six flavours • Parmesan cheese • Cheezlets • Vital milk in all markets 	<ul style="list-style-type: none"> • New flavours in Topp-up of pistachio and Butterscotch • Cheese sandwich slices • Cheese toppings for pizzas • Spiced buttermilk in UHT • Fresh cream in UHT • Spiced buttermilk in Fino pack 	<ul style="list-style-type: none"> • Whey proteins • Sachet packs of ghee • Buttermilk in southern spices variant • Go Badam Milk • Go Almette Creamed Cottage Cheese in two flavours • Go Chutney cheese slices 	<ul style="list-style-type: none"> • Spice-up Flavoured cheese slices • Curd 10kg Bucket • Badam Milk Instant Mix • Cheese Wedges – Herbs and spices 	<ul style="list-style-type: none"> • Milk Rich - Milk whitener • Avvatar - Whey protein • Slurp-Mango beverage

Competitive strength – Differentiated brand and product portfolio

Brands Portfolio



Pricing power and Positioning



Target Customer Group



- Targeted at household consumers seeking premium quality cow's milk
- Targeted for health enthusiasts



- Targeted at children and the youth generation, primarily for direct consumption
- Targeted at youth generation & travellers as source of instant nourishment



- Targeted for traditional Indian recipes and cooking ingredients
- Targeted at Indian households

Product Portfolio of Parag Milk Foods



Small Packs For Rural Consumption



9 ml Ghee sachet



200 gm Curd pouch



200 ml small UHT milk

New Products Launched in FY17



Badam milk mix - 20 gm



Cheese wedges - herbs and slices



Go - Spice up in 5 new cheese flavors



Avvatar - 2.3 kg sports nutrition protein powder



Milkrich - dairy whitener



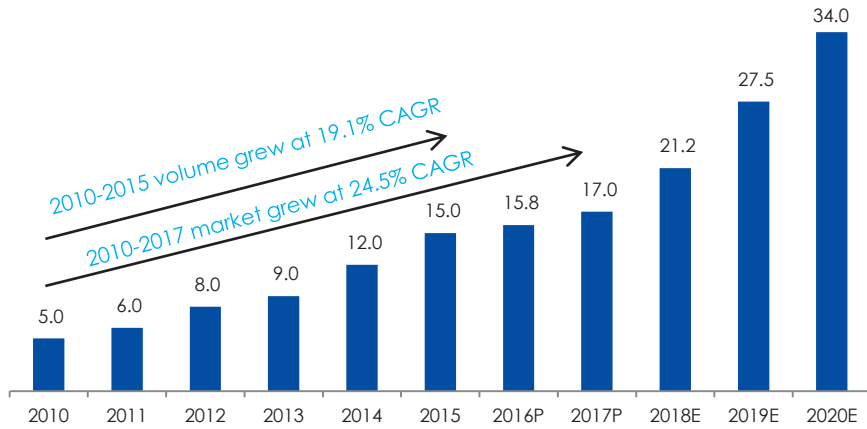
Slurp - 200ml Mango Drink

A) Indian cheese market: Opportunities galore; to post >20% CAGR

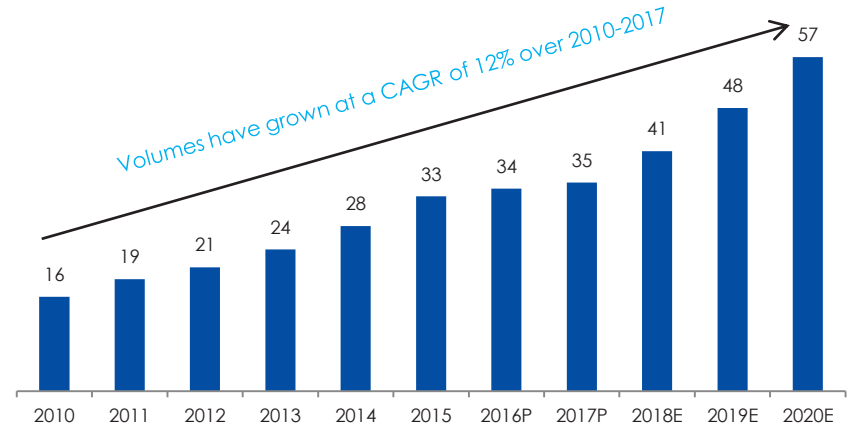
- Cheese is one of the fastest growing markets among dairy products. Traditionally, India has been a paneer consuming market, dominated by unorganised players. The rise in food service outlets (e.g., Pizza Hut, Domino's) across the country and changing food habits have catapulted demand for cheese. The Indian cheese market clocked CAGR of 19.1% over 2010-17 led by 12% volume growth, reaching a value of INR 1,700 crore for FY17. The growth in the cheese market was much stronger up till FY15, wherein it grew at 25% CAGR for 5 years from FY12-15, but weak macro environment, slowing sales of QSR and restarutants resulted in weak volume uptake for last 18-24 months starting 2016 onwards.

- Going forward, with the revival in the macro environment, and increasing transition towards western cuisines, the cheese segment is likely to grow at double digit, thus it is expected that the market would grow at 26% CAGR over FY17-20E from INR17 bn in FY17 to INR 34 bn in FY20E
- Maharashtra is the top cheese consuming state in India, accounting for 33%, followed by Gujarat, Delhi and Tamil Nadu which account for 16%, 7% and 7%, respectively.
- Key players in the organised cheese segment are Amul, Parag and Britannia accounting for 42%, 32% and 9%, respectively. While Amul dominates the retail segment, Parag is the leader in the institutional segment.

Indian Cheese Market (INR bn)

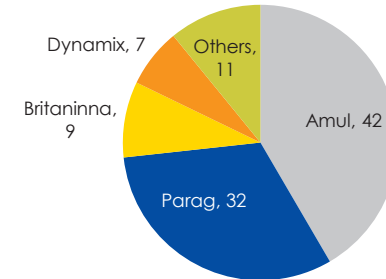
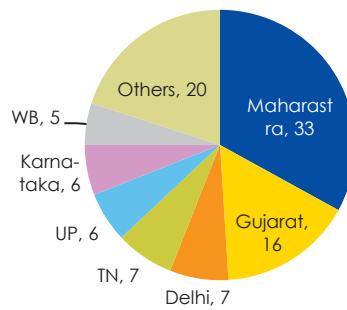
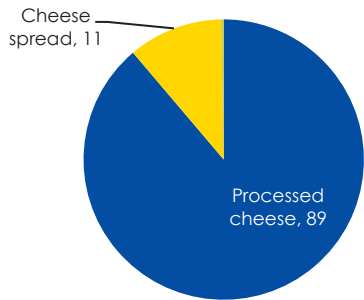


Cheese volumes (000 tons)



Source: Industry, Edelweiss Investment Research

Region wise cheese market size



Source: Company, Edelweiss Investment Research

With 32% market share and innovative product pipeline Parag to post stellar growth in cheese

In the cheese segment, Parag has a market share of 32%, which puts it in the second position after Amul. Major players in the cheese market such as Amul and Britannia have not introduced new products over the past 3 years. We believe, Parag scores high on innovation the front.

Parag's innovative subsegmentation & premiumization drive in cheese

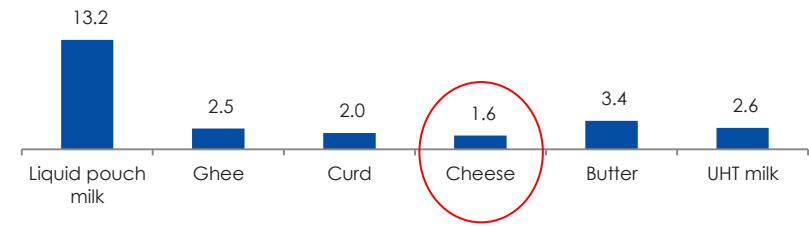
Segment	Basic Cheese	Pizza Cheese	Slices	Slices with spices	Slices with chutney	Spread	Creamy	Cheese Sauce	Spread for Kids	Variants
Britannia	Britannia Cheese	Britannia Cheese	Britannia Cheese slices	NP	NP	Britannia Cheese Spreadz	Britannia Cream cheese	NP	NP	Processed Mozzarella
Amul	Amul Cheese	Amul Pizza Mozzarella cheese	Amul Cheese smlices	NP	NP	Amul Cheese Spread	NP	NP	NP	Processed Emmentaal, Gouda, Mozzarella
Parag	Go Cheese	Go Pizza Cheese	Go Cheese slices	Go Cheese slices with herbs	Go Cheese slices with chutney	Go Cheese spread	Go Cheese creamy spread	Go Cheese Sauce	Go Cheezooz	Processed, Emmentaal, Gouda, Mozzarella, Cheddar, Colby

- Cheese accounts for 20% of Parag's top line and has posted CAGR of 24% over FY14-17. The company's cheese plant at Manchar currently has a capacity of 60mt/day, up from 40 mt/day in FY16. The plant is capable to producing cheese in 75 stock-keeping units under a wide range, including cheddar, mozzarella, processed and gourmet cheese. The cheese facility is running at 60% capacity.
- Expansion in cheese is in line with Parag's strategy of focusing on value-added and higher-margin products. While the company has a strong presence in the institutional segment (supplies to McCainFoods, Jubilant Foodworks, Yum Foods, Sam's Pizza, MTR Foods, Mother Dairy, etc), network expansion and increase in advertisement & promotional expenses should improve retail share of cheese products as well. Of the total cheese revenue, around 50% comes from institutions and 50% from retail. The company has also roped in Chef Ranveer Brar for brand communication related to cheese to gain further traction in the growing market.
- Manufacturing and marketing of cheese is a capital intensive business, requiring capex as well as working capital. Hence, the cheese market is largely organised. With Parag's capacity already in place (60 mt/day) and

utilisation level at around 65% going forward with improving utilisation with no commensurate capex, revenue and earnings are likely to improve further.

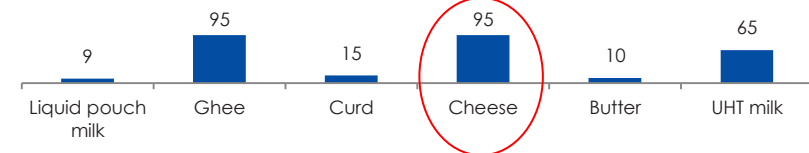
Product wise asset turnover (x)

Cheese has lowest asset turnover



Product wise working capital intensity (No of days)

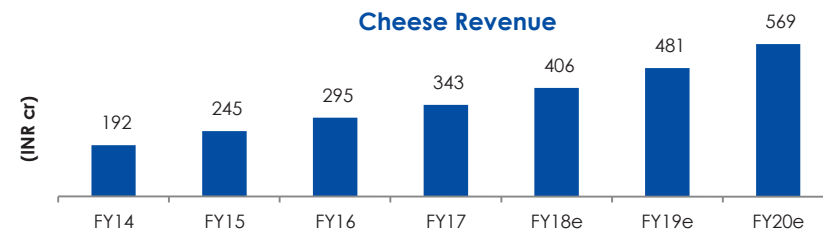
And demands high working capital days



Cheese has lowest asset turns and high working capital making it capital intensive, thus offers higher margins and would continue to be organized. Parag has created a mark for itself in Cheese, and hence via innovation and branding commanding higher realization and margins in the category.

Driven by improvement in utilisation resulting in volume and realisation growth, we estimate Parag's cheese revenue to post CAGR of 19% over FY17-20E

Cheese Revenue

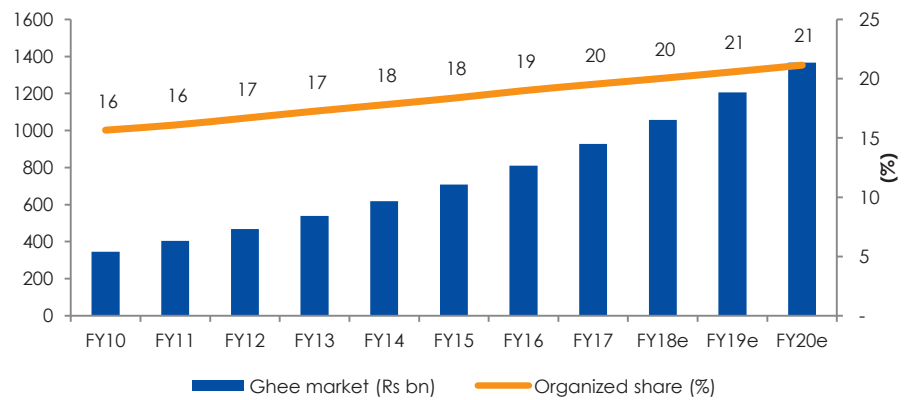


Source: Company, Edelweiss Investment Research

B) Indian ghee market: Traditional and unorganised moving towards organised; Parag's product offerings & brand pull render it preferred choice

- The Indian ghee market posted CAGR of 15.2% over 2010-17, reaching a value of INR 927 bn. Ghee is the second most consumed product of the Indian dairy industry. The market is dominated by the unorganised segment, accounting for 80% of total ghee sales; the organised segment accounts for 20%.

Indian Ghee Market (INR bn)

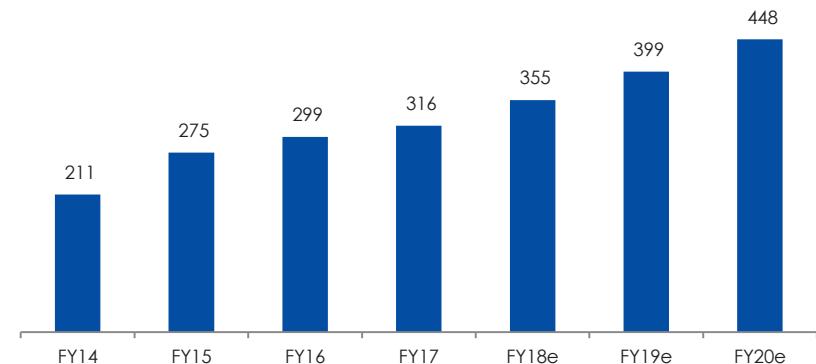


Source: Industry, Edelweiss Investment Research

- In the organised market, the bulk segment, which consists of ghee in 10-15 kg packs, currently accounts for around 45% of total ghee sold in the country. This segment mainly caters to the institutional market.
- Smaller packs catering to the retail market currently account for around 55% of the total ghee market.
- South India represents the largest market for ghee in India accounting for 26.6%, followed by North India (26.5%), East India (24.3%) and West India (22.6%).
- Pure cow ghee currently accounts for less than 10% of the total ghee market. The segment is currently growing faster than the overall ghee market and has higher margins.

- Parag is the pioneer in the cow ghee segment and also the biggest player. Other major players include Amul, Patanjali, KMF Cooperative and Dynamix Dairies.
- Ghee constitutes around 20% of Parag's revenue and has posted CAGR of 14.5% over FY14-17. Parag has created a unique brand positioning for its ghee on the basis of being 100% derived from cow's milk and on purity. Thus, going forward, we believe the company's unique positioning around purity coupled with its strong brand image and rising shift towards organised players are likely to propel higher growth for the category. We estimate the category for Parag to post revenue CAGR of 12.4% over FY17-20.

Ghee Revenue (INR cr)



Source: Company, Edelweiss Investment Research

(C) Other innovative & premium products: Pride Of Cows

Parag sells premium milk through its subsidiary Bhagalaxmi Dairy under the brand Pride of Cows. Thus, in a basic commodity market of milk, the company has successfully created an ultra premium brand with pricing being 2x the normal price. Parag has set up a dairy farm with ~ 2,000 holstein cows in Manchar. Thus, the product is truly integrated right from the farm till branding. The farm is fully automated with best practices of breeding and feeding animals, which enables the company to generate extremely high quality milk.



As distribution needs to be in proximity to production & processing set up for milk, the distribution for *Pride of Cow* is at Mumbai, Pune and Surat. Revenue from the brand has registered CAGR of 21.7% from INR 30 crore in FY15 to INR 45 crore in FY17, with improvement in profitability.

The brand is currently being serviced in Mumbai, Thane, Navi Mumbai, Pimpri-Chinchwad, and Pune, with an active customer base of over 15,000+ households.

Driving innovation by converting waste into useful marketable products- Focus on new initiatives such as biosciences

Apart from selling premium milk under the brand "Pride of Cow", the company has now created a special bio science division, and has introduced certified organic fertilizers through the commercialization of cow manure and cow urine into value added products. These products are marketed and sold under the brand –

- Bhagalaxmi MICRO RICH- Liquid plant growth fertilizer
- Bhagalaxmi Agrifeed- Farm Yard Manure
- Bhagalaxmi Gold mine- Phosphate rich manure
- Bhagalaxmi Nutricane- sugar crop manure

All these products are 100% organic, made out of waste of cows (which the company has on its farm) used as manure or fertilizer to improve productivity and develop resistance towards disease and pests.

			
Liquid plant growth fertilizer	Farm Yard Manure	Phosphate rich organic manure	Sugar crop manure
<ul style="list-style-type: none"> Organic slurry released as a by-product from the Biogas plant 100% organic and natural and rich in plant nutrients Increases resistance against pests & diseases 	<ul style="list-style-type: none"> Prepared from pure cow dung Useful for all kinds of crops Improves soil fertility & soil productivity Safe for soil micro flora 	<ul style="list-style-type: none"> Produced by co-composting high-grade phosphate rock with organic waste Increases the moisture storage capacity of the soil and makes the soil smooth & healthy Reduces cost of fertilization 	<ul style="list-style-type: none"> Helps to improve the production and productivity of the sugarcane crop Improves water and nutrients uptake Reduces the use of chemical fertilizers

The manufacture of these products does not entail any additional raw material cost, but mere innovation in technology and marketing, which the company is successfully undertaking. We believe, with the introduction of these innovative products, profitability and margin of the subsidiary is bound to improve going ahead.

(D) Various new and promising product rollouts & Future rollouts – To reflect on financials ahead

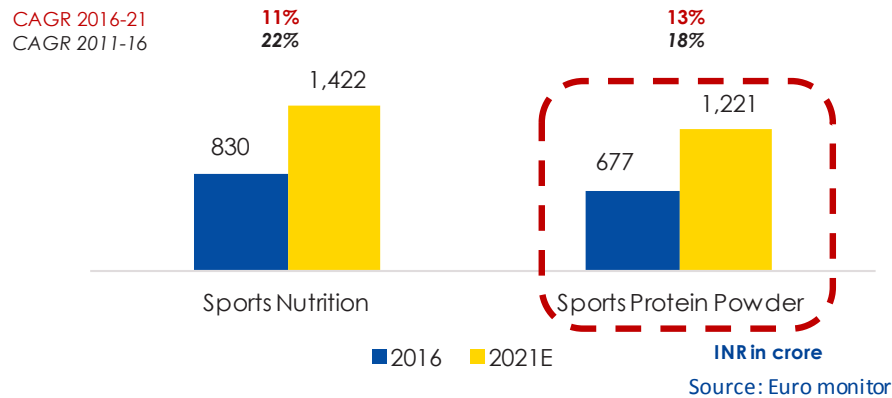
(a) Whey protein under Avvatar brand

- Whey is a component of milk protein. It is generated as a by-product during the manufacture of cheese.
- 1 kg cheese generates 50% (i.e 500 gms) of whey. This is a very good source of protein and is most sought after protein drink in the sports nutrition category.
- Till now, the company was selling whey in crude form to the institutional segment. However, it has recently launched whey protein in retail under the Avvatar brand, which is sold directly to end consumers. Thus, Parag has entered a new and promising product category of sports nutrition.



- According to Euro Monitor, the sports protein powder category is pegged at INR 700 crore, reporting 18% CAGR over FY11-16. The category is estimated to post CAGR of 13% over the next 4 years to INR 1220 crore by 2021.
- Currently, the market is dominated by imported brands that constitute around 80-90% of the overall pie. There is no domestic brand in the market. Thus, with introduction of Avvatar, Parag has entered into a high growth, high margin product.
- The product will be distributed via tie ups with premium sports gyms, nutrition outlets and e-portals.

Sports Nutrition Industry



Entry into Consumer whey further expands Parag's portfolio providing fillip to margins and earnings

- Whey is the byproduct of cheese which gives clear advantage to Parag to enter the category.
- The entry into the category would result in expansion of company's market presence through the introduction of new route to market channels
- It further broadens Parag's portfolio of higher margin products
- It exploits its advanced technology in the dairy sector

(a) Entry into mango based fruit juice market with introduction of brand "Slurp"



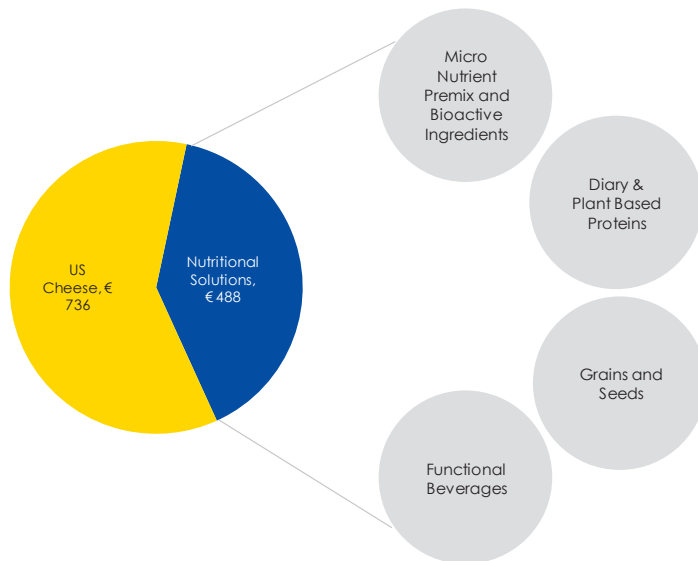
(b) Likely foray into mass protein products & Likely introduction of new high immunity booster product called "Colostrum "

Case Study: Global Giant Glanbia with focus on health and nutrition

Glanbia is a global nutrition company grounded in science and nature and dedicated to providing better nutrition for every step in life's journey.

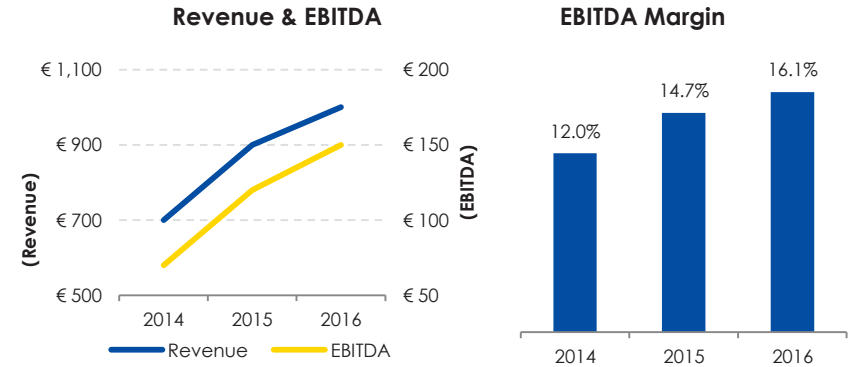
The company has an annual turnover of €3.6 billion. Its major production facilities are located in Ireland, the US, the UK, Germany and China. It has four segments; Glanbia Performance Nutrition, Global Ingredients, Dairy Ireland and Joint Ventures & Associates. Its shares are listed on the Irish and London Stock Exchanges (symbol: GLB).

GN Capability Overview 2016 Revenue



Parag is following the Glanbia route, whereby the company is focusing on high margin and nutrition based dairy products, which provides high growth along with high margin. Glanbia follows an asset light capex and expansion plan whereby expansion is led by JV. This unique combination enables the company to enjoy margins in excess of 16%+ with higher RoCE. We believe Parag has a long term potential to reach Glanbia margins and RoCE.

Glanbia Performance Nutrition



Source: Company, Edelweiss Investment Research

Joint Ventures and Associates

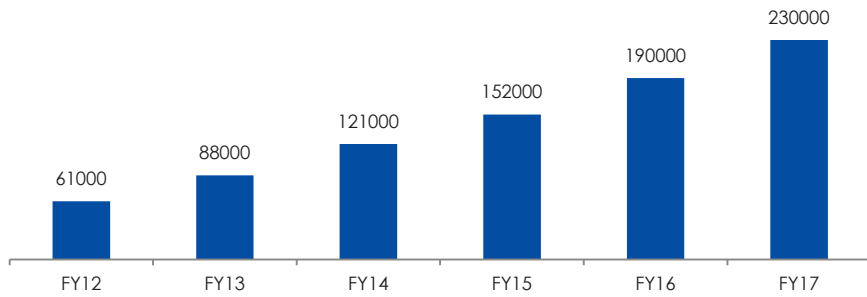
3 scale partners in dairy processing	In 2016 Glanbia share of revenue from JV's and Associates was
Glanbia Ingredients Ireland (40% partner)	Largest dairy process in Ireland
Southwest Cheese (50% partner)	Large-scale American style cheddar cheese and whey producer located in New Mexico
Glanbia Cheese (51% partner)	Leader in mozzarella cheese in the EU

Glanbia total Group processed over 6 million litres of milk in 2016

(IV) Improving and expanding distribution reach with focus on optimization to enhance brand presence and lower selling cost

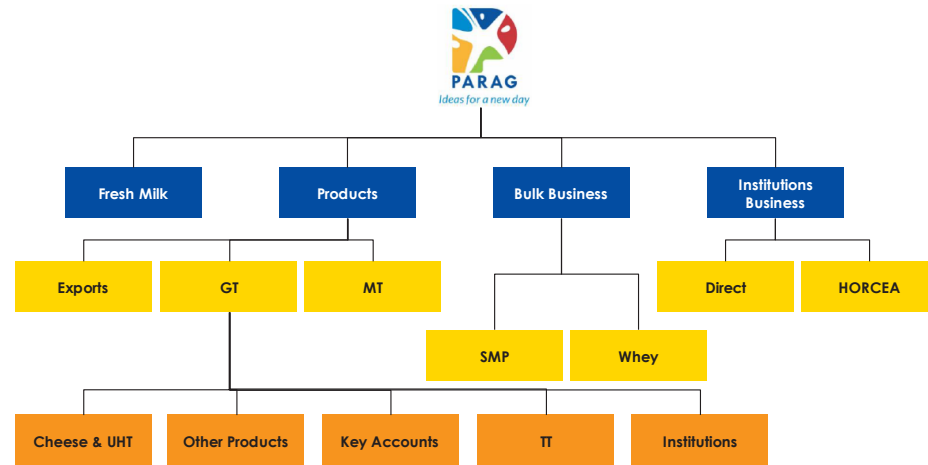
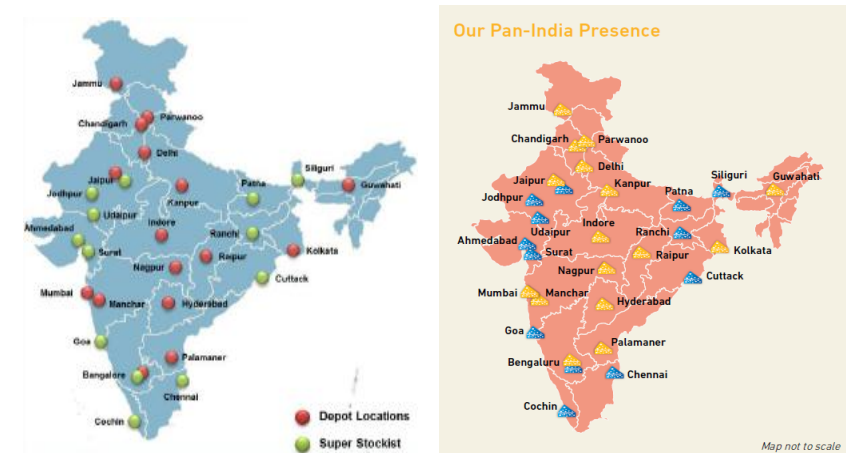
Parag has expanded its distribution network from covering 61,000 retail touch points in FY12 to over 2,30,000 by FY17 end and in the next three years the company expects to reach over 3.5 lac retail touchpoints. Parag distributes its products broadly in three ways:

Increasing Retail Touch Points (nos)

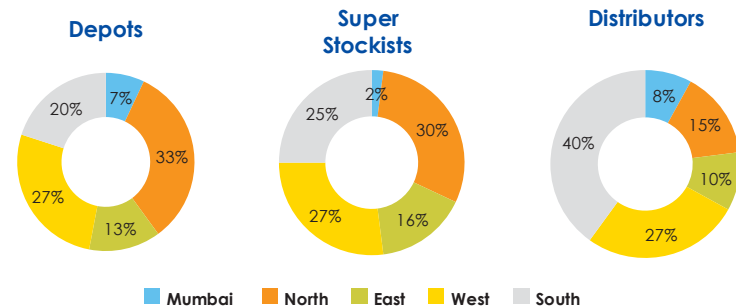


Source: Company, Edelweiss Investment Research

- 1) **Fresh milk Products** – Fresh products like Milk, Dahi, which have limited shelf life are distributed in Maharashtra and Mumbai from the Manchar plant, while in the south these are distributed from the Palamner plant
- 2) **Cold storage value added products**- Cheese, Paneer and other value added products like butter are distributed and are sold Pan India through distributors and transported via chilled vans.
- 3) **High shelf products** – High shelf products that do not require refrigeration and are shelf stable products like ghee, dairy whitener are sold pan India via distributors.



Regionwise Distribution Network in India



Source: Company, Edelweiss Investment Research

Distribution and selling cost optimisation via appointment of Vector Consulting Group

In order to expand its distribution reach, reduce stock outs along with eyeing inventory rationalisation at the distributors' & company level, Parag has appointed Vector Consultants to drive the company's distribution model.

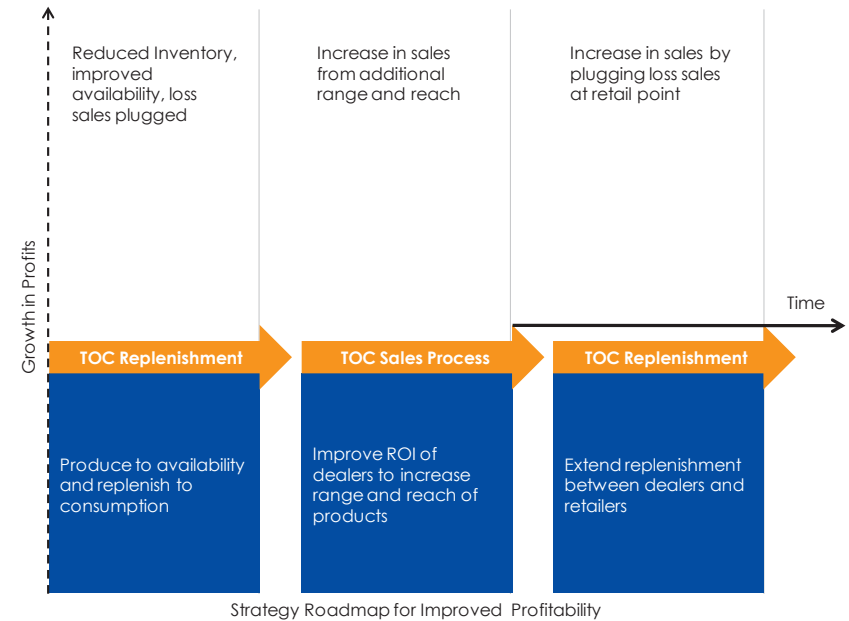
The consultant is working on "Theory of Constraints" method to improve the distribution reach, with lower stock outs and enabling better rationalisation of inventory at dealers, retailers and the company level.

We believe, this effort is likely to improve the depth and width of Parag's distribution, enabling higher presence, reach and also aid inventory optimisation.

Currently, Parag's selling & distribution along with advertising costs stand at 6-7%, of which pure selling cost is around 4.0-4.5%. With improvement in distribution reach and depth, along with increase in sales, we believe leverage is likely to play on selling and distribution cost, which will benefit margins going ahead.

Further with under the theory, you do not produce what you do not sell, your non-moving inventory dips drastically and cash does not get blocked in what is termed bad inventory. This is likely to aid/ help in case of inventory management and revenue improvement.

Vector consultants framework



Vector Consultants & Theory of Constraints: What's it and how it helps

Leading consultant; engaged with renowned group: The Vector Consulting Group is a leading consulting firm in the space of Theory of Constraints Consulting in India. It engages with organisations to help them gain market share by building unique supply chain capabilities that provide a competitive edge in the market. The Group is engaged with India's most renowned industrial houses such as Tata, Godrej, Bajaj Electricals, Cummins Group, Raymonds, among others.

Changing production from forecasting to linking to market trends

- The vector mode of Theory of Constraints works on specific norms and algorithms which trigger production leads based on sales of a particular stock-keeping unit (SKU). With the theory, you do not produce what you do not sell, your non-moving inventory dips drastically and cash does not get blocked in what is termed bad inventory. This is likely to aid/ help in case of inventory management and revenue improvement.
- Production is linked to sales. So, if the company sells one piece, production is also one piece. It's linked from the front to the back end. So, the forecast for a new brand happens once sales kick in, typically in two months' time which is the usual norm. Production happens on the basis of sales. Whichever brand is doing well, will be produced more. It's a system-generated model in terms of identifying the right products that are selling.
- Earlier, what is manufactured was sold. Manufacturing efficiencies decided what you would manufacture and the sales team would sell and distribute it. Because by the time information in terms of what is sold reaches the manufacturing unit it would be a few weeks. But now it's possible to get all the information on real-time basis. So, possibilities have emerged where manufacturing can align with what is happening on the sales front.

Benefits

- Improving reach and enhanced distribution.
- Making the right product available at the right time.
- Rationalisation of inventory.
- Improvement of RoI at distributors and the company level.

V) Capex already undertaken, benefits to follow

Over the past 2 years, Parag has increased capacity on various counts: (a) increased milk handling & processing capacity from 2.0 mn litres per day to 2.4 mn litres per day; (b) increased cheese capacity from 40 tonnes per day to 60 tonnes per day; (c) created a separate paneer manufacturing facility with capacity of 20 tons per day; and (d) undertook capex to upgrade the whey facility to manufacture consumer whey. Currently, its plants are running at 55-60% utilisation levels, which is likely to take care of the near term capex. The company has around INR 65 crore fund from IPO proceeds, which would be used for enhancing procurement and chilling infrastructure going ahead. With relatively low capex requirement, improvement in working capital needs and likely growth in key categories, we expect Parag's margins and return ratios to improve.

Valuation

Parag, being an integrated dairy player with focus on value-added dairy products (65-70% of overall portfolio), is in a unique position to reap dual benefits of a dairy company coupled with a FMCG play in the long run .

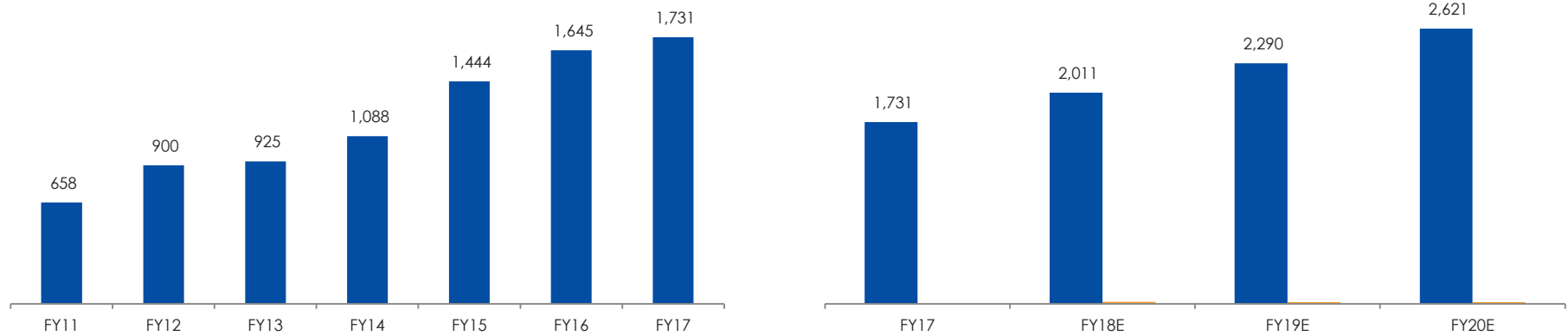
The company has moved up the value chain in terms of product portfolio, which is likely to improve gross margin. Already Parag has one of the highest gross margins in the industry.

Given the strong structural tailwinds, coupled with exemplary focus on branding, communication and reach along with a bouquet of innovative products, Parag is likely to trade at premium valuations akin to FMCG players. Hence, we assign PER of 31x to FY19E EPS of Rs 9.6 to arrive at our price target of Rs 300.

Financial performance

Revenue expected to post 14.8% CAGR over FY17-20 driven by growth in value-added segment: Parag has reported healthy revenue growth of 16.7% over FY14-17 driven by robust growth in the value-added portfolio (a combination of product and SKU expansion). We estimate the company to post CAGR of 14.8% over FY17-20, driven by healthy growth in the key value-added product categories like cheese, ghee along with new product introduction—whey, Slurrp—along with expansion in distribution footprint.

Revenue from operations (INR cr)

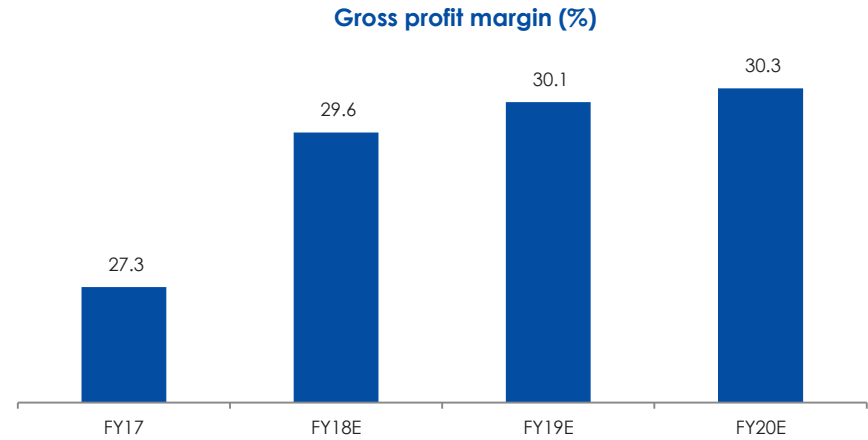
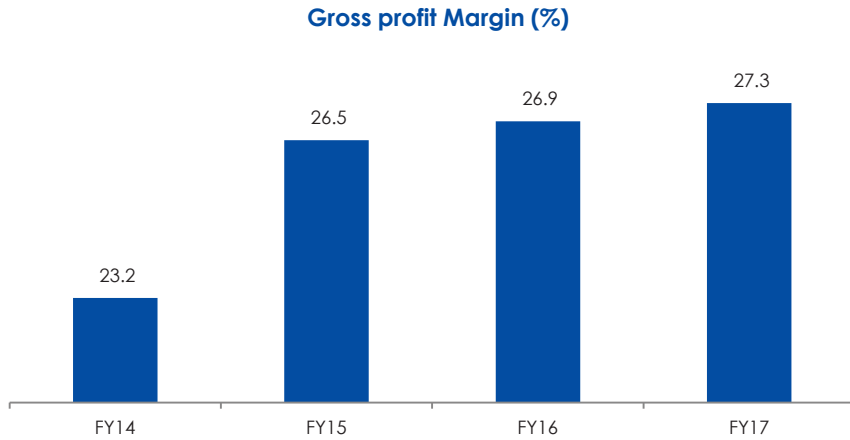


Source: Company, Edelweiss Investment Research

Premiumisation drive has aided gross margin expansion

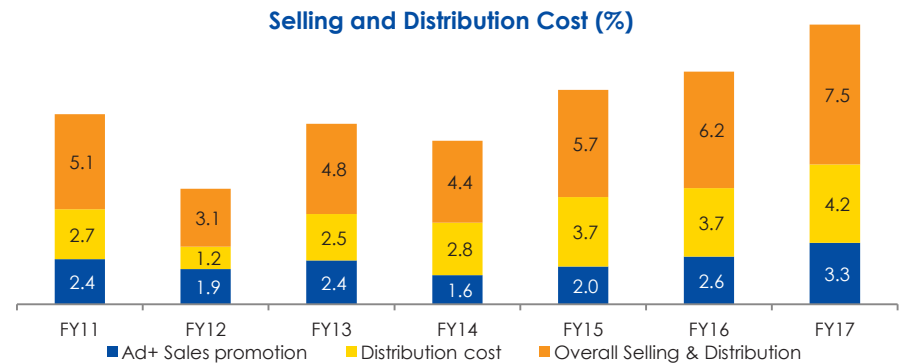
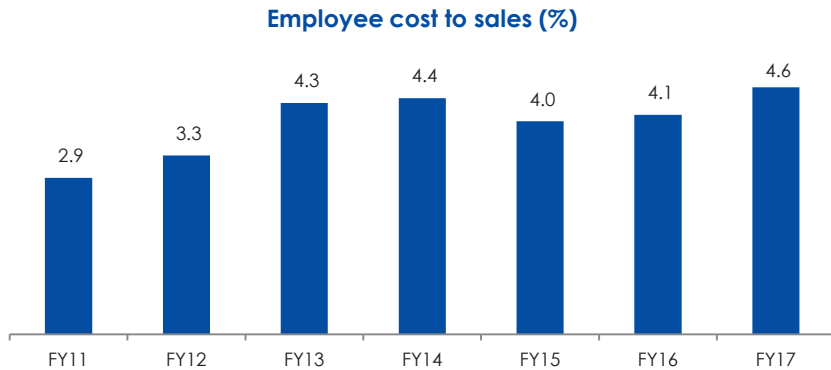
Parag is steadily growing its value-added product portfolio and launching various innovative and high margin new products. Further, within the value-added product portfolio, the company is moving towards premium products. The testimony to its premiumisation drive is the gross margin expansion seen at the company level despite sharp increase in price of key raw material price—milk.

Thus, going forward, led by stable milk prices coupled with its premiumisation drive, we expect an overall 280 bps improvement in overall gross margins. Thus, the gross margin is estimated to improve from 27.3% in FY17 to 30.1% in FY19.



Source: Company, Edelweiss Investment Research

EBITDA to clock 35% CAGR over FY17-20E; combination of gross margin expansion along with operating leverage playing out: Over the past 4 years, Parag's EBITDA has clocked CAGR of 9.5%. Till FY16, the company's margin expanded consistently from 7.4% in FY14 to 9.0% in FY16. FY17 was a bad year for the company, wherein despite premiumisation, gross margin improvement was lower on account of high raw material prices (although underlying gross margin witnessed good improvement) coupled with this, volumes in the value-added category did not take off as expected, resulting in EBITDA margin contraction.



Source: Company, Edelweiss Investment Research

Parag Milk Foods Ltd.

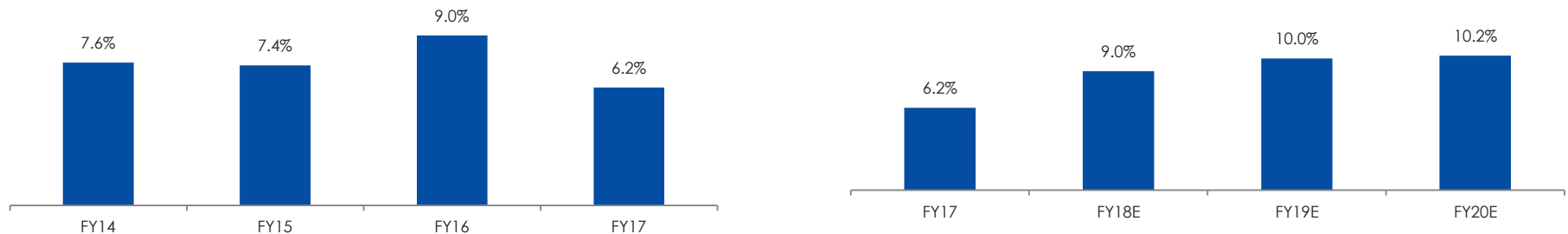
- **Increase in employee expenses:** Building for scale, Parag has over the years expanded its bandwidth, which has resulted in increase in employee cost—from INR 19 crore in FY11 to INR 80 crore in FY17. The overall employee cost to sales has almost doubled from 2.9% in FY11 to 4.6% in FY17.
- **Sharp increase in overall selling and distribution expenses:** Akin to a FMCG play, to create pull and improve distribution network, Parag has over the past 4 years consistently increased spends on promotion, advertisement and distribution reach. Overall absolute spends on selling and distribution reach has grown 4x from INR 36 crore in FY11 to INR 130 crore in FY17.

As a fallout of these overhead expenses, Parag's EBITDA margin expansion was lower than gross margin expansion. Its EBITDA margin has declined from 7.6% in FY11 to 6.2% in FY17.

Going forward, with improvement in sales, along with premiumisation drive and leverage on the fixed costs (employee and selling & distribution) coming to play, we believe EBITDA margin expansion will be healthy.

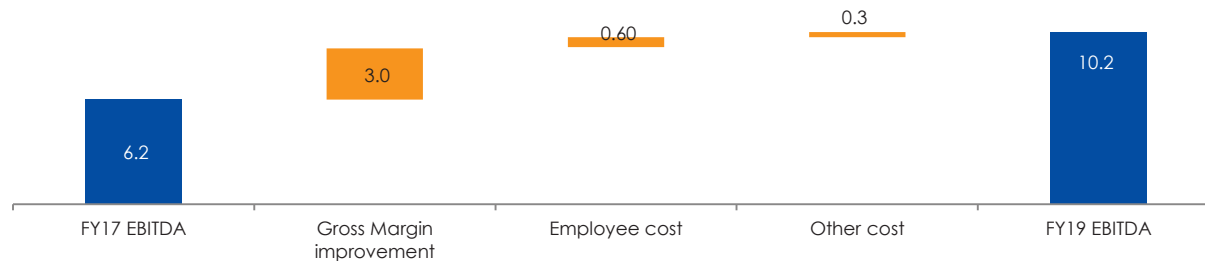
We are factoring 400 bps EBITDA margin improvement for Parag from 6.2% in FY17 to 10.2% by FY20.

EBITDA Margins



Source: Company, Edelweiss Investment Research

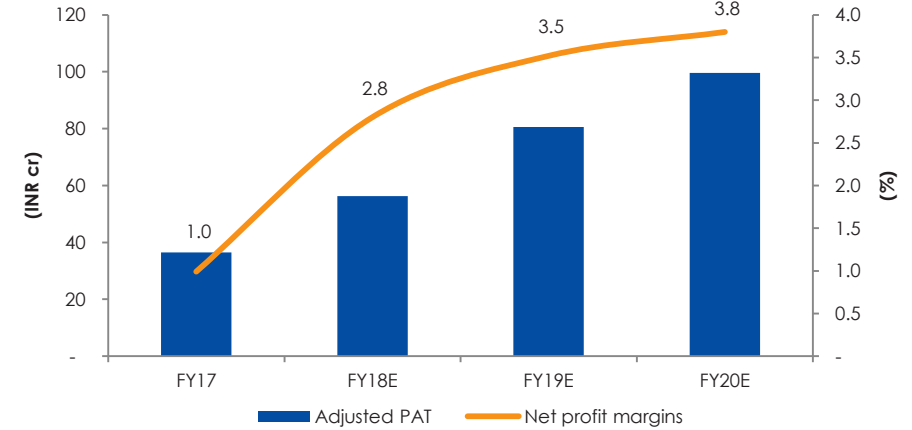
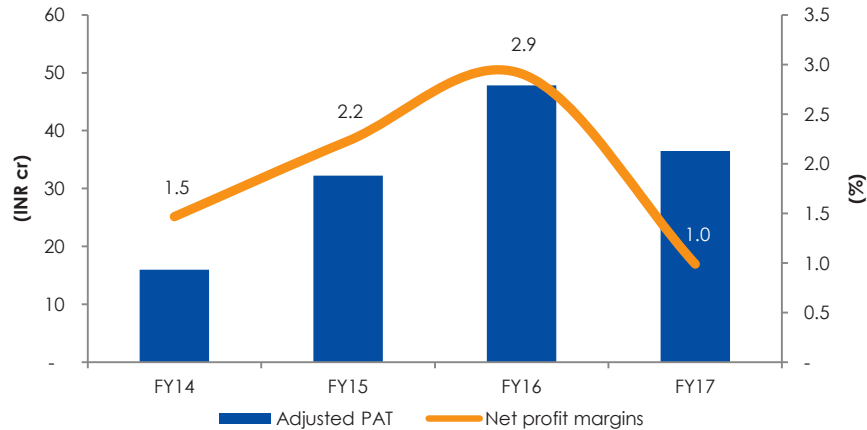
EBITDA margin to improve from 6.2% to 10.2% aided by gross margin improvement and reduction in other cost



Source: Company, Edelweiss Investment Research

Net earnings to post 40% CAGR over FY17-20E: Led by healthy improvement in EBITDA (we estimate 35.2% CAGR over FY17-20), coupled with financial leverage playing out (finance and depreciation expense expected to clock lower CAGR of 16.5% and 9.5% over FY17-20E), we estimate Parag's net earnings to register a robust 40% CAGR over FY17-20. We expect Parag to post net earnings of INR 100 crore by FY20E from adjusted earnings of INR 37 crore in FY17.

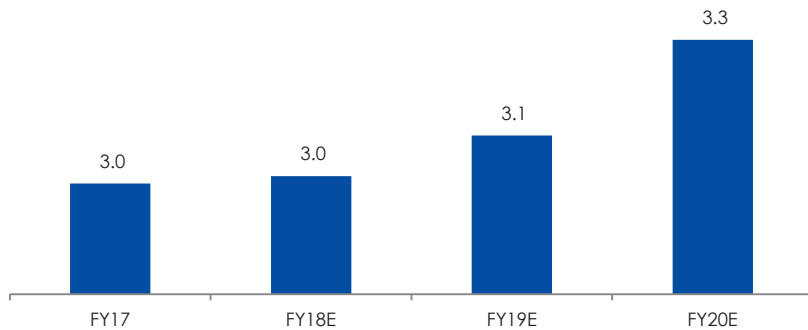
Net Profit & Margins



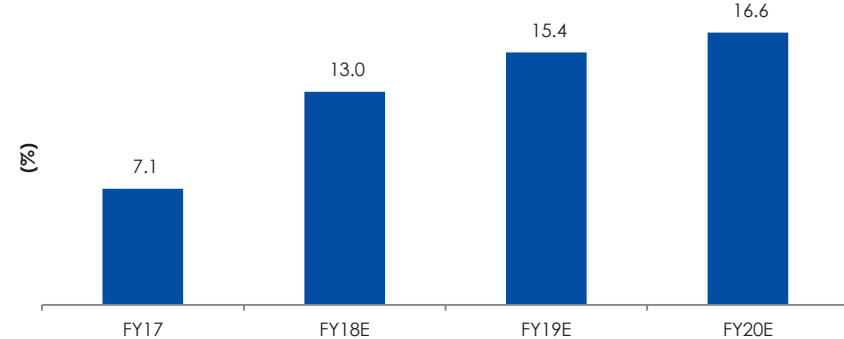
Source: Company, Edelweiss Investment Research

Margin improvement and higher asset turns to result in healthy improvement in return ratios: Led by margin improvement coupled with improving asset turns, we estimate RoCE to improve significantly from current 7.0% to 16.6% in FY20

Asset Turnover (x)



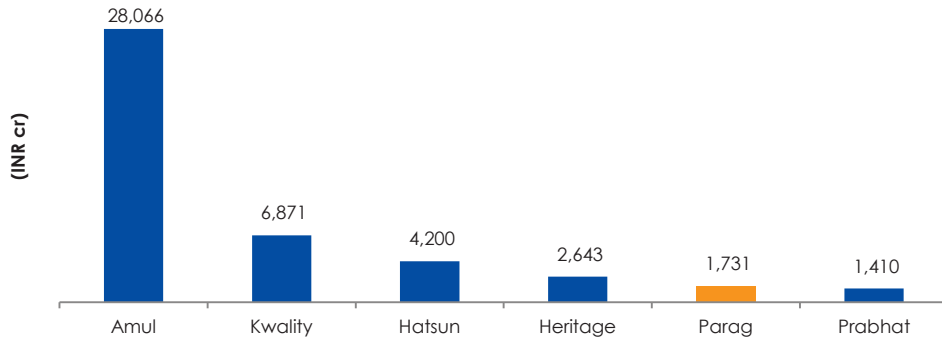
RoCE



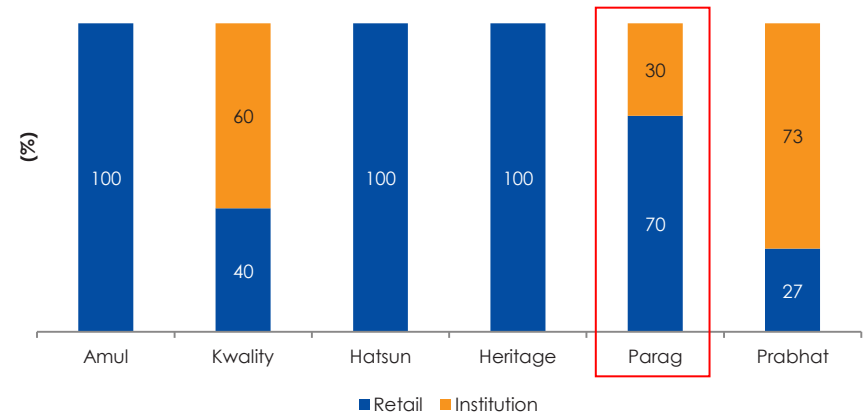
Source: Company, Edelweiss Investment Research

Peer comparison

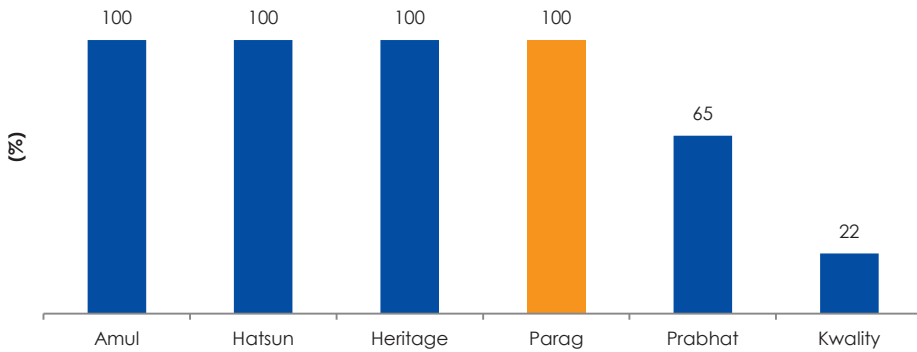
Revenue FY17



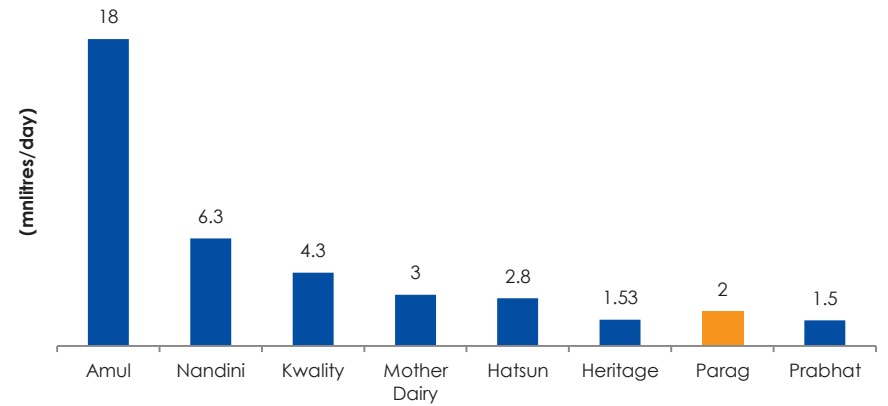
Channel wise revenue mix across players



Direct Procurement reach of key players (% to total procurement)

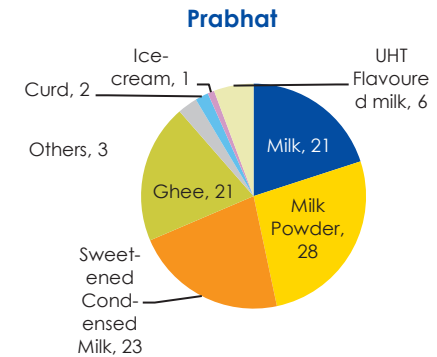
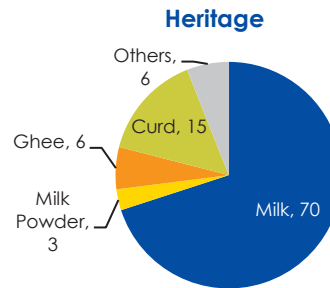
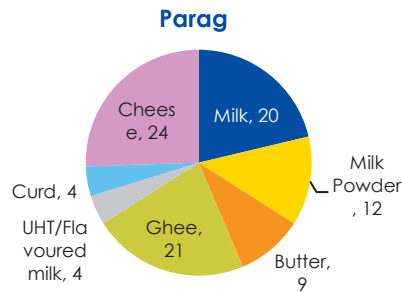
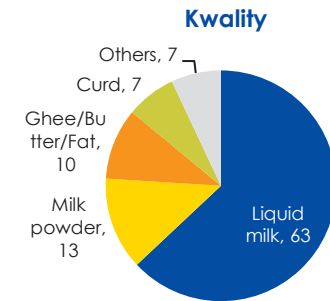
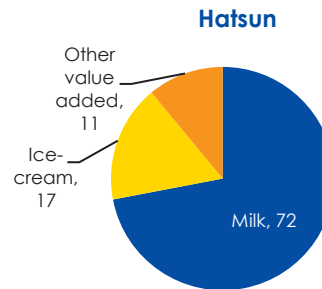
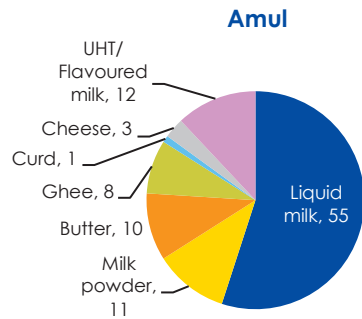


Processing Capacity of key players (mlitres/day)



Source: Company, Edelweiss Investment Research

FY17 Product profile of the key industry players



Source: Company, Edelweiss Investment Research

Peer Comparison Financials

Company	CMP	M-cap	FY17					PER			EV/EBITDA			Mcap/Sales		
			Revenue	EBITDA margin	PAT	RoCE	RoE	FY17	FY18E	FY19E	FY17	FY18E	FY19E	FY17	FY18E	FY19E
Parag Milk Foods	225	1,895	1,731	6.2	36.0	6.2	5.5	52.6	33.6	23.4	19.1	15.2	11.4	1.1	1.0	0.8
Prabhat Dairy	132	1,287	1,410	9.0	66	10.8	9.6	19.5	24.9	15.7	12.7	8.8	6.7	0.9	0.8	0.7
Heritage Foods	1,230	2,854	2,643	5.3	67	24.2	24.7	42.6	28.1	23.3	21.5	13.5	11.7	1.1	1.3	1.1
Hatsun	622	9,460	4,200	9.0	134	21.3	38.6	70.6	58.1	47.8	26.7	20.6	16.8	2.3	1.9	1.6
Kwality Ltd	135	3,216	6,871	6.6	193	14.85	17.3	16.7	13.2	9.8	10.5	8.6	7	0.5	0.4	0.4

Key risks

- Increase in the procurement prices
- High capex intensity

Business Overview

Company Brief

Parag Milk Foods is a

Business Model	The company is a value added milk player with an integrated business model from farming, procuring, processing to branding and distribution. Milk based value added products constitutes around 65-70% to the overall revenue.
Strategic Positioning	The company is the only private value added player with clear focus on new value added and nutritional offerings. Over the years the company has created a pan India distribution reach for the products, and now has a retail touch points over 2.3 lac retailers.
Competitive Edge	Value added player, with strong and innovative product portfolio made from 100% Cow's milk. Over the years has created a Pan India distribution reach
Financial Structure	The company is focusing on further improving its product portfolio with premiumization drive to improve gross margins, and also increasingly focusing on driving EBITDA margin performance with better distribution, and lower leads
Key Competitors	Amul and other regional players
Industry Revenue Drivers	Strong transition from unorganized to organized play; along with increasing preference to value added milk based dairy product consumption to drive revenue for the company
Shareholder Value Proposition	The company will likely record an EPS of INR 9.6 for FY19. At valuation of 31x its FY10, we arrive at a price target of INR 300 which offers an upside of 33% from the current levels.

About the company in charts

Leadership in Dairy FMCG space

- 

Second largest market share in Cheese
- 

Most trusted Brand recognised by TRA in the Gowardhan Ghee for 2nd consecutive year
- 

Branded player in "Farm to Home" premium milk
- 

Leading private player in UHT category
- 

Avvatar – India's first company to launch truly made in India Whey protein powder

Processing Facility



Bhagalaxmi Dairy, Pune

Palamaner Plant, Andra Pradesh

Marketing campaign undertaken by the company

Parag Milk Foods assigns creative mandate to JWT for our flagship products 'Gowardhan' Ghee and 'GO' Cheese



Focused marketing campaign for 'Cow Ghee' with new slogan – 'Pyaar ka Rang Sunehra'

Association for Go Cheese with popular Celebrity Chef – 'Ranveer Brar' and new campaign for Go Spice-up with 'Vir Das'



Ranveer Brar using Go cheese chutney slice on his show 'Good to Go' Vir Das promoting Peri Peri cheese slice of Spice up box

New products launched during FY16-17



- Products launched during FY17
- Go "Cheese Wedges – Herbs and Spices"
 - Go "Badam Milk Instant Mix"
 - "Spice up" box in 5 New Flavoured Cheese Slices
 - Milkrich – Dairy Whitener
 - Avvatar – Whey Protein powder
 - Slurp - Mango drink with dash of milk

Journey So Far

1992

Parag Milk Foods Limited started in 1992 to help farmers by collecting milk on milk holidays during Operation Flood. Back then, Parag was primarily involved in the distribution and collection of milk

2008

Commissioned "Go Cheese World" - India's largest cheese manufacturing plant with a capacity of 40 MT per day

2010

The Palamaner plant was established with a world-class UHT facility

2012

The concept of Dairy Tourism was brought to life for the first time in India by us

2015

Remodelled the brand Parag with a new identity

2016

We got listed on the bourses, thus becoming a publicly branded and owned entity

1998

The year witnessed the birth of Bhagyalaxmi Dairy Farm - India's most modern dairy farm with the finest international equipments

2005

We commissioned our Manchar plant and began manufacturing traditional products like Butter and Ghee under the brand, 'Gowardhan'

2011

The year saw the birth of 'Pride of Cows', a first-of-its-kind premium farm-to-home milk brand

2014

On realising the needs of our institutional clients, we launched B2B whey protein

2017

Entered into the Juice drink market by launching a mango drink with a dash of milk

Launched a 100% Whey protein, first-of-its-kind manufactured in India. From our farm to your shaker cup, fresh and pure

Financials

Income Statement					(INR cr)	Balance sheet					Ratios						
Year to March	FY16	FY17	FY18E	FY19E	FY20E	As on 31st March	FY16	FY17	FY18E	FY19E	FY20E	Year to March	FY16	FY17	FY18E	FY19E	FY20E
Income from operations	1,645	1,731	2,011	2,290	2,621	Share Capital	70	84	84	84	84	ROAE (%)	19.7	7.2	8.2	10.7	11.8
Direct costs	1,203	1,259	1,415	1,601	1,827	Reserves And Surplus	291	573	630	710	810	ROACE (%)	17.4	7.1	13.0	15.4	16.6
Employee costs	67.1	79.4	90.5	91.6	104.8	Share holders fund	362	657	714	794	894	Debtors (days)	52.4	45.3	52.0	52.0	52.0
Other expenses	226.9	284.3	323.7	368.6	422.0	Total Debt	361	233	300	335	376	Current ratio	2.5	2.1	3.0	3.1	3.2
Total operating expenses	1,497	1,623	1,829	2,061	2,354	Long-Term Borrowings	125	71	71	71	71	Debt/Equity	1.0	0.4	0.4	0.4	0.4
EBITDA	148	108	181	229	267	Short-Term Borrowings	236	162	229	263	305	Inventory (days)	60.4	90.4	60.0	60.0	60.0
Depreciation and amortisation	33.4	49.0	54.1	59.7	63.7	Other Non-Current Liabilities	30	28	26	26	26	Payable (days)	37.2	65.8	35.0	35.0	35.0
EBIT	115	59	127	169	203	Deferred Tax Liabilities (Net)	11	10	10	10	10	Cash conversion cycle (days)	75.6	69.9	77.0	77.0	77.0
Interest expenses	49.0	33.3	42.0	46.9	52.6	Other Long-Term Liabilities	18	17	17	17	17	Debt/EBITDA	2.4	2.2	1.7	1.5	1.4
Profit before tax	67	37	85	122	151	Long-Term Provisions	1	2	-	-	-	Adjusted debt/Equity	1.0	0.4	0.4	0.4	0.4
Provision for tax	19.5	0.4	29.0	41.5	51.3	Sources of Funds	752	919	1,040	1,155	1,296	Valuation Parameters					
Core profit	48	37	56	81	100	Fixed Assets	373	379	395	406	392	Diluted EPS (INR)	5.7	4.3	6.7	9.6	11.8
Profit after tax	48	17	56	81	100	Gross Block	528	585	676	746	796	Y-o-Y growth (%)	48.5	-23.7	54.2	43.1	23.6
Adjusted net profit	48	17	56	81	100	Acc. D&A	183	226	280	340	404	CEPS (INR)	22.2	5.3	17.9	22.2	25.7
Equity shares outstanding (cr)	7.0	8.4	8.4	8.4	8.4	Net Block	345	359	395	406	392	Diluted P/E (x)	39.5	51.8	33.6	23.5	19.0
EPS (INR) basic	6.8	2.0	6.7	9.6	11.8	Other Non-Current Assets	17	73	73	73	73	Price/BV(x)	5.2	2.9	2.7	2.4	2.1
Diluted shares (Cr)	8.4	8.4	8.4	8.4	8.4	Long-Term Loans And Advances	16	71	71	71	71	EV/Sales (x)	1.3	1.1	1.0	0.9	0.8
EPS (INR) fully diluted	5.7	4.3	6.7	9.6	11.8	Other Non-Current Assets	1	2	2	2	2	EV/EBITDA (x)	14.5	17.9	11.6	9.3	7.9
Common size metrics- as % of net revenues						Current Assets	602	878	864	977	1,112	Diluted shares O/S	8.4	8.4	8.4	8.4	8.4
Year to March	FY16	FY17	FY18E	FY19E	FY20E	Inventories	272	429	331	376	431	Basic EPS	5.7	4.3	6.7	9.6	11.8
COGS	73.1	72.7	70.4	69.9	69.7	Trade Receivables	236	215	286	326	373	Basic PE (x)	39.5	51.8	33.6	23.5	19.0
Operating expenses	91.0	93.8	91.0	90.0	89.8	Cash And Bank Balances	8	101	0	19	70						
Depreciation	2.0	2.8	2.7	2.6	2.4	Short-Term Loans And Advances	45	88	201	229	262						
Interest expenditure	3.0	1.9	2.1	2.0	2.0	Other Current Assets	40	46	46	46	46						
Gross profit margin (%)	26.9	27.3	29.6	30.1	30.3	Current Liabilities	239	411	292	319	351						
EBITDA margins	9.0	6.2	9.0	10.0	10.2	Trade Payables	168	312	193	220	251						
Net profit margins	2.9	1.0	2.8	3.5	3.8	Other Current Liabilities	67	98	98	98	98						
Growth metrics (%)						Short-Term Provisions	4	2	2	2	2						
Year to March	FY16	FY17	FY18E	FY19E	FY20E	Net Current Assets	363	467	572	658	761						
Revenues	13.9	5.2	16.2	13.9	14.5	Application of Funds	752	919	1,040	1,155	1,296						
EBITDA	38.3	-27.1	67.7	26.0	16.9	Cash flow statement											
PBT	96.5	-45.2	131.1	43.1	23.6	Year to March	FY16	FY17	FY18E	FY19E	FY20E						
Net profit	48.5	-64.2	228.8	43.1	23.6	Net profit	48	37	56	81	100						
EPS	48.5	-23.7	54.2	43.1	23.6	+ Depreciation & Amortisation	38	43	54	60	64						
						+ Interest Expense	49	33	42	47	53						
						- Other Income	(2)	(11)	-	-	-						
						Operating Cash Flow before WC Changes	187	44	151	187	216						
						Cash Flow from Operating Activities	9	34	(55)	100	113						
						Capex	(89)	(39)	(70)	(70)	(50)						
						Free Cash Flow	(80)	(5)	(125)	30	63						

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Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate between 5-15% over a 12-month period
Reduce	Return below 5% over a 12-month period

Parag Milk Foods price chart



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