

30 April 2010

Patni Computer Systems

Wins large deal; maintain Buy

Rating: Buy

Target Price: Rs645

Share Price: Rs535

- Patni wins historic deal in 1QFY10.** Patni's 1Q profit beat our estimate by 12.9%, mainly on higher forex gains. Revenue slid 1.9% qoq (in rupee terms) and grew 1.3% (in dollars). Patni won a five-year deal from Universal American Corp., to provide end-to-end policy administration services (could become US\$250m, indicated by the company).
- Earnings guidance – sluggish near term.** Patni has guided to 2QFY10 revenue of US\$171m-172m, implying 0.8-0.2% qoq drop, lower than guidance given by other IT companies. However, we believe that once the new deal starts ramping up, incremental revenue of US\$50m a year (from the five-year US\$250m deal), would add ~6% to existing revenue. On constant currency basis, Patni grew 1.9% qoq.
- Other key points.** Product engineering services (up 7.3% qoq) and Asia Pacific (+23.1%) were the primary growth drivers. Fixed price projects' (FPP) share rose 120bp qoq to 43.6%, aiding margins. The company has US\$467m in cash (Rs163 a share).
- Acquisition.** Along with the deal, Patni will acquire CHCS Services, Inc., a subsidiary of Universal American. The acquisition would provide Patni a footing in the insurance and healthcare sector, and enhance its present BPO capabilities.
- Valuation.** Our new target price of Rs645 comprises Rs535 (at a target PE of 13x 12-month forward EPS) and Rs110 (valuing the cash above the average 10% peer cash holding), inline with peers.

Key data	PATNI IN / PTNI.BO
52-week high/low	Rs593/ Rs150
Sensex/Nifty	17503/5254
3-m average volume	US\$3.5m
Market cap	Rs69bn/US\$1.6bn
Shares outstanding	129m
Free float	53.5%
Promoters	46.5%
Foreign Institutions	41.2%
Domestic Institutions	7.0%
Public	5.4%

Quarterly results

Year-end 31 Dec	1QFY09	1QFY10	% yoy	FY08	FY09	% yoy
Sales (Rsm)	7,969	7,745	(2.8)	31,991	31,634	(1.1)
EBITDA (Rsm)	1,335	1,594	19.4	5,049	6,090	20.6
EBITDA margin (%)	16.8	20.6	383bps	15.8	19.2	347bps
Interest (Rsm)	-	-	-	-	-	-
Depreciation (Rsm)	192	182	(5.3)	782	782	0.0
Other income (Rsm)	-202	412	NM	491	657	33.8
PBT (Rsm)	941	1,825	94.0	4,758	5,965	25.4
Tax (Rsm)	180	328	82.1	214	241	12.7
Tax rate (%)	19.1	18.0	(117)bps	4.5	4.0	(45)bps
PAT (Rsm)	761	1,497	96.8	4,544	5,723	26.0

Source: Company, Anand Rathi Research

Financials

Year-end 31 Dec	FY10e	FY11e
Sales (Rsm)	31,211	35,734
Net profit (Rsm)	5,484	5,671
EPS (Rs)	42.1	43.1
Growth (%)	(5.0)	2.5
PE (x)	12.7	12.4
PBV (x)	1.7	1.5
RoE (%)	14.6	13.2
RoCE (%)	18.0	17.6
Dividend yield (%)	0.6	0.7
Net gearing (%)	(61.0)	(65.0)

Source: Bloomberg, Anand Rathi Research

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Quick Glance – Financials and Valuations

Fig 1 – Income statement (Rsm)

Year end 31 Dec	FY08	FY09	FY10e	FY11e	FY12e
Net sales	31,991	31,634	31,211	35,734	41,700
Sales growth (%)	18.7	(1.1)	(1.3)	14.5	16.7
- Op. expenses	26,942	25,545	24,910	28,559	33,357
EBIDTA	5,049	6,090	6,301	7,175	8,344
EBITDA margins (%)	15.8	19.2	20.2	20.1	20.0
- Interest	-	-	-	-	-
- Depreciation	782	782	732	761	819
+ Other income	491	657	1,158	1,163	1,240
- Tax	214	241	1,243	1,906	2,454
PAT	4,544	5,723	5,484	5,671	6,310
PAT growth (%)	(2.1)	26.0	(4.2)	3.4	11.3
Consolidated PAT	4,544	5,723	5,484	5,671	6,310
FDEPS (Rs/share)	33.0	44.3	42.1	43.1	47.6
CEPS (Rs/share)	38.7	50.4	47.7	48.9	53.8
DPS (Rs/share)	3.0	3.0	3.0	3.5	4.0

Source: Company, Anand Rathi Research

Fig 2 – Balance sheet (Rsm)

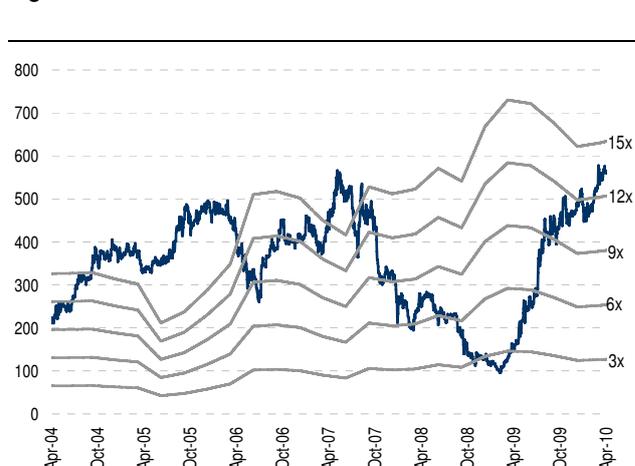
Year end 31 Dec	FY08	FY09	FY10e	FY11e	FY12e
Share capital	256	258	260	263	265
Reserves & surplus	27,481	34,404	39,981	45,354	51,283
Shareholders' fund	27,737	34,662	40,241	45,617	51,549
Debt	9	4	4	4	4
Minority interests	-	-	-	-	-
Capital employed	27,746	34,667	40,245	45,620	51,552
Fixed assets	7,332	6,850	6,611	6,972	7,453
Investments	16,416	21,557	22,293	22,293	22,293
Working capital	1,076	3,315	4,754	5,533	6,569
Cash	2,922	2,945	6,586	10,822	15,237
Capital deployed	27,746	34,667	40,245	45,620	51,552
No. of shares (m)	138	129	130	131	133
Net Debt/Equity (%)	(53.5)	(58.8)	(61.0)	(65.0)	(68.6)
W C turn (days)	12.3	38.2	55.6	56.5	57.5

Source: Company, Anand Rathi Research

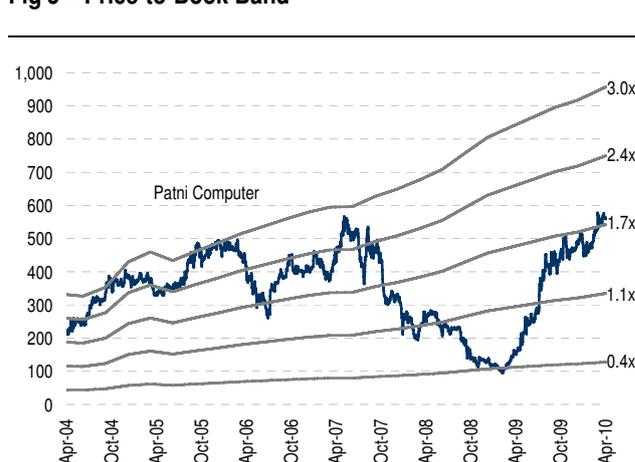
Fig 3 – Cash flow statement (Rsm)

Year end 31 Dec	FY08	FY09	FY10e	FY11e	FY12e
Consolidated PAT	4,544	5,723	5,484	5,671	6,310
+ Depreciation	782	782	732	761	819
Cash profit	5,326	6,505	6,216	6,432	7,130
- Incr/(Decr) in WC	(2,128)	2,238	1,439	779	1,036
Operating cash flow	7,454	4,267	4,777	5,653	6,093
- Capex	1,374	300	493	1,122	1,300
Free cash flow	6,080	3,967	4,284	4,531	4,793
- Dividend	450	453	457	538	621
+ Equity raised	(3,194)	1,655	552	243	243
+ Debt raised	(4)	(5)	(1)	-	-
- Investments	780	5,141	736	-	-
- Misc. items	-	-	-	-	-
Net cash flow	1,652	23	3,642	4,235	4,415
+ Opening cash	1,269	2,922	2,945	6,586	10,822
Closing cash	2,922	2,945	6,586	10,822	15,237

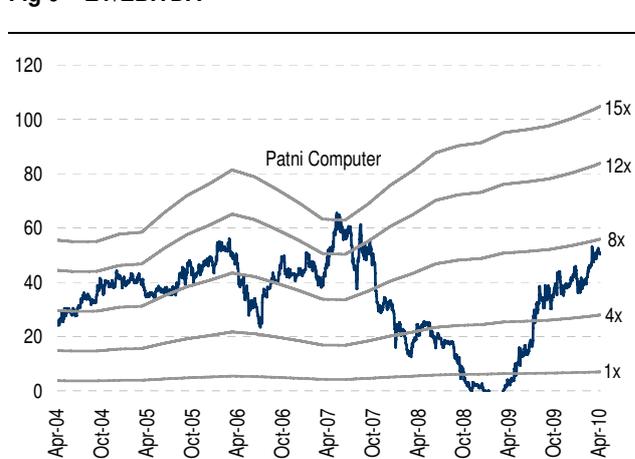
Source: Company, Anand Rathi Research

Fig 4 – PE Band


Source: Bloomberg, Anand Rathi Research

Fig 5 – Price-to-Book Band


Source: Bloomberg, Anand Rathi Research

Fig 6 – EV/EBITDA


Source: Bloomberg, Anand Rathi Research

Results Review

Patni's 1QFY10 revenue slid 1.9% qoq (rupee) and grew 1.3% (US\$). The margin was up 30bp mainly on account of lower cost of revenue sequentially. Consolidated net profit was higher than we expected, on account of lower depreciation and higher forex gains.

Revenue analysis

Revenue for 1QFY10 stood at Rs7,745m, 2.3% lower than our estimates in rupee terms. The average Rs/US\$ rate realized for 4QFY10 was 45 vis-à-vis our assumption of 45.5.

In dollar terms, revenue stood at US\$172.3m, a 1.3% qoq increase and 1.1% lower than our estimates. 36 employees (net) left Patni in 1QFY10 to take the total headcount to 13,959 (vis-à-vis our expectation of 14,265). Blended utilization for the quarter stood at 79.9% vs our expected 77%.

EBITDA margin

EBITDA margin came 69bp higher than we expected on account of lower-than-expected cost of revenue.

Non-operating items

Other income – 'Other income' was higher than our estimate. Foreign exchange profit for 1QFY10 stood at Rs214m, vis-à-vis our estimate of Rs82m.

Effective tax rate – The tax rate stood at 18%, vis-à-vis our assumption of 19%.

Net profit growth

Net profit was 12.9% higher than our estimate chiefly on account of higher-than-expected forex gains.

Fig 7 – Quarterly details

(Rsm)	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10
Sales	7,837	8,523	8,570	7,969	7,729	8,040	7,896	7,745
Growth % (yoy)	18.2	26.5	24.9	12.9	(1.4)	(5.7)	(7.9)	(2.8)
Growth % (qoq)	11.0	8.7	0.6	(7.0)	(3.0)	4.0	(1.8)	(1.9)
EBITDA	1,115	1,431	1,526	1,335	1,549	1,605	1,601	1,594
EBITDA margin (%)	14.2	16.8	17.8	16.8	20.0	20.0	20.3	20.6
Growth % (yoy)	(2.4)	37.8	44.4	36.7	38.9	12.1	4.9	19.4
Growth % (qoq)	14.2	28.4	6.6	(12.5)	16.0	3.6	(0.2)	(0.4)
Depreciation	193	202	194	192	193	193	204	182
Interest expense	-	-	-	-	-	-	-	-
Other income	285	582	(435)	(202)	339	175	346	412
PBT	1,207	1,812	898	941	1,694	1,587	1,743	1,825
Taxes	170	(190)	117	180	326	(129)	(135)	328
PAT	1,037	2,002	780	761	1,368	1,716	1,878	1,497
Consolidated PAT	1,037	2,002	780	761	1,368	1,716	1,878	1,497
Growth % (yoy)	(23.0)	82.4	(21.8)	5.0	31.9	(14.3)	140.8	96.8
Growth % (qoq)	43.1	93.0	(61.0)	(2.5)	79.9	25.4	9.5	(20.3)
EPS (Rs)	7.5	15.4	6.1	5.9	10.7	13.4	14.5	11.6

Source: Company, Anand Rathi Research

Other key points

- For 2QFY10, Patni has guided to revenue of US\$171-172m, translating to 0.8-0.2% qoq decrease. Net profit guidance has been given as US\$27-28m, which at Rs45.5/US\$ translates into FDEPS of Rs10 for 2QFY10 (without considering forex).
- The cash and cash equivalents have gone up from Rs20.4bn (Rs158/share) at Dec-end to Rs21bn (Rs163/share) at Mar-end.
- At end-Mar '10, the company increased its forex cover to US\$356m (US\$320 at Dec-end). This translates to 2.1x 2QFY10e revenue.
- Client #2-4 grew 5.6% (ITM) qoq, while clients six to ten 0.8%; the top client grew 1.1%. The company added nine (gross) clients, taking the active client list to 260.
- All geographical areas slid sequentially for Patni except Asia Pacific. Asia Pacific was up 23.1%, while the US and EMEA were down 2.9% and 6.1%, respectively. Industry-wise, Product Engineering service was up 7.3% qoq, while Insurance and Financial services were down 6.7% and 4.4%, respectively. On a constant currency basis, Patni grew 1.9% qoq.
- Onsite mix of revenue was up 170bp qoq to 46.8%. FPP jumped 120bp qoq to 43.6% helping Patni enhance the margin.
- Patni has announced an offshore and onsite wage hike of 12% and 3%, respectively, with effect from Apr'10.
- **Large deal win:** Patni bagged a five-year deal from Universal American Corp. to provide end-to-end policy administration services. It could become a US\$250m-deal, as management indicated in the conference call. So at US\$50m a year, that would add ~6% in incremental revenue once the deal starts ramping up. It has also signed a definitive agreement to acquire CHCS Services, Inc. (for a consideration of less than US\$10m), a wholly-owned subsidiary of Universal American. The acquisition creates a new hub for Patni in Pensacola, Florida, and establishes a new line of business for Patni as a third-party administrator (TPA) in the insurance and healthcare sectors, enhancing its present BPO capabilities.

Changes in Estimates and Valuation

We raise our FY10 EPS estimate 0.6% to Rs42.1 while lowering that of FY11 by 1.9% to Rs43.1. We increase our target multiple to 13x 12-month forward FDEPS (12x earlier) to arrive at Rs535 and Rs110 (valuing the cash above the average 10% peer cash holding). Hence, we raise our target price to Rs645 and maintain our Buy rating.

Fig 8 – Changes in estimates

(Rsm)	FY10e			FY11e			FY12e		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Revenue (US\$m)	732	700	(4.4)	847	803	(5.2)	957	937	(2.1)
Revenue	33,021	31,211	(5.5)	38,122	35,734	(6.3)	43,060	41,700	(3.2)
EBITDA margin	20.1	20.2	10bps	20.0	20.1	10bps	19.9	20.0	10bps
Consolidated PAT	5,456	5,484	0.5	5,786	5,671	(2.0)	6,303	6,310	0.1
EPS	41.9	42.1	0.6	44.0	43.1	(1.9)	47.5	47.6	0.2

Source: Anand Rathi Research

Major estimate changes

- 1 We have altered our Rs/US\$ conversion to 44.5 for FY11/12 from the earlier assumed 45, due to rupee movements against the dollar.
- 2 Pricing changes have occurred due to differences in actual and estimated 1QFY10 prices. The pricing changes do not factor in any cross-currency movements.
- 3 Volume assumptions for FY10/11/12 are a combination of healthy traction due to deal win, changes in the headcount during 1QFY10 and “guidance” for 2QFY10. The company has mentioned it would be more focused on higher productivity than merely adding headcount.
- 4 We have factored in the wage hike, effective 1 Apr '10, for both kinds of employees, onsite and offshore.

Valuation

We assign Patni a target price of Rs645, based on a target PE of 13x 12-month forward EPS of Rs41.2 (Rs535) and adding Rs110 for its cash holding (excess cash holding over the industry average of 10% of their market-cap; see Fig 10).

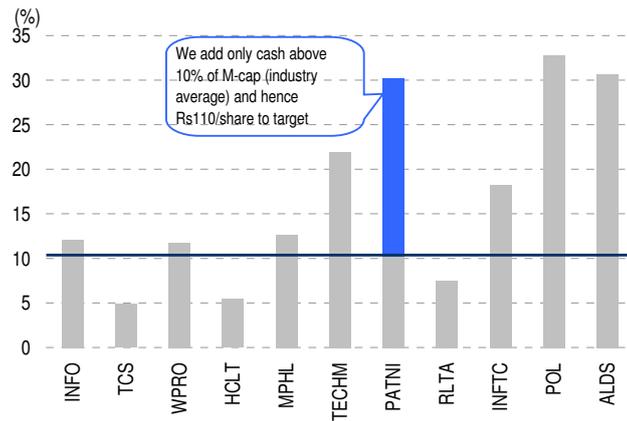
Our target multiple of 13x 12-month forward EPS is in line with the target multiples given to its peers and at a ~35% discount it has traded to average large-cap forward PEs. Our average FY11 target PE multiple for the large-caps is 19.7x (see Fig 9).

Fig 9 – IT companies' FY11 target multiples

IT large caps	1-year forward PE	IT mid-caps	1-year forward PE
Infosys	24.0	Rolta	12.0
TCS	24.0	Infotech Enterprises	14.0
Wipro	24.0	Polaris	12.0
HCL Tech	17.0	Mindtree*	14.0
Tech Mahindra (core)	12.0	Firstsource*	12.8
Mphasis	17.0		
IT large caps	19.7	IT Mid-caps	13.0

Source: Anand Rathi Research. *Bloomberg consensus

Fig 10 – Adding Rs110/share to PE-based price



Source: Company, Anand Rathi Research

Risks to our target price

Client concentration risk. Patni’s revenue has traditionally been highly concentrated among a few clients. In FY09, 36.5% came from the top five, and the top ten accounted for 49.8%.

High dependence on ADM and the US. Patni has high exposure to mature ADM services (65.2% for FY09) and low exposure to growth segments such as infrastructure management services and systems integration. It received ~80% of its FY09 revenue from the US. These verticals could be causes for worry in case they slow down.

Fig 11 – Income statement

Year-end 31 Dec (Rsm)	FY08	FY09	FY10e	FY11e	FY12e
Revenues	31,991	31,634	31,211	35,734	41,700
Growth (%)	18.7	(1.1)	(1.3)	14.5	16.7
Average currency rate (Rs/US\$)	44.5	48.3	44.6	44.5	44.5
Depreciation (%)	9.3	8.5	(7.6)	(0.3)	-
Employees	14,894	13,995	14,854	17,774	19,907
Growth (%)	(0.3)	(6.0)	6.1	19.7	12.0
Software engineers	13,331	12,511	13,439	16,359	18,414
% of total employees	89.5	89.4	90.5	92.0	92.5
Revenue/software engineer (US\$ '000)	53.6	50.7	53.9	53.9	53.9
Growth (%)	1.4	(5.4)	6.3	(0.0)	-
Expenses	26,942	25,545	24,910	28,559	33,375
As % of revenue (%)	84.2	80.8	79.8	79.9	80.0
Cost of services	21,028	19,555	18,662	21,759	25,757
As % of revenue (%)	65.7	61.8	59.8	60.9	61.8
Cost / Employee (Rs '000)	1,409.4	1,353.8	1,293.8	1,333.7	1,367.1
Inflation (%)	11.6	(3.9)	(4.4)	3.1	2.5
Other costs	5,914	5,990	6,248	6,800	7,600
As % of revenue (%)	18.5	18.9	20.0	19.0	18.2
EBITDA	5,049	6,090	6,301	7,175	8,344
EBITDA margin (%)	15.8	19.2	20.2	20.1	20.0
Interest	-	-	-	-	-
Depreciation	782	782	732	761	819
Other income	491	657	1,158	1,163	1,240
PBT	4,758	5,965	6,727	7,577	8,764
Tax	214	241	1,243	1,906	2,454
Effective tax rate (%)	4.5	4.0	18.5	25.2	28.0
PAT	4,544	5,723	5,484	5,671	6,310
Minority interest	-	-	-	-	-
Consolidated PAT	4,544	5,723	5,484	5,671	6,310
Extraordinary expenses	-	-	-	-	-
Reported PAT	4,544	5,723	5,484	5,671	6,310

Source : Company, Anand Rathi Research

Fig 12 – Balance sheet

Year-end 31 Dec (Rsm)	FY08	FY09	FY10e	FY11e	FY12e
Equity	256	258	260	263	265
Reserves	27,481	34,404	39,981	45,354	51,283
Shareholders' funds	27,737	34,662	40,241	45,617	51,549
Debt	9	4	4	4	4
Capital employed	27,746	34,667	40,245	45,620	51,552
Fixed assets	7,332	6,850	6,611	6,972	7,453
Investments	16,416	21,557	22,293	22,293	22,293
Cash	2,922	2,945	6,586	10,822	15,237
Working capital	1,076	3,315	4,754	5,533	6,569
Capital employed	27,746	34,667	40,245	45,620	51,552

Source : Company, Anand Rathi Research

Fig 13 – Cash-flow statement

Year-end 31 Dec (Rsm)	FY08	FY09	FY10e	FY11e	FY12e
PAT	4,544	5,723	5,484	5,671	6,310
+ non-cash expense	782	782	732	761	819
Cash profit	5,326	6,505	6,216	6,432	7,130
- Increase/(decrease) in working capital	(2,128)	2,238	1,439	779	1,036
Operating cash flow	7,454	4,267	4,777	5,653	6,093
- Capex	1,374	300	493	1,122	1,300
Free cash flow	6,080	3,967	4,284	4,531	4,793
+ Equity raised	(3,194)	1,655	552	243	243
+ Debt raised	(4)	(5)	(1)	-	-
- Investments	780	5,141	736	-	-
- Dividend paid	450	453	457	538	621
- Misc. expense	-	-	-	-	-
Net change in cash	1,652	23	3,642	4,235	4,415
Opening cash	1,269	2,922	2,945	6,586	10,822
Closing cash	2,922	2,945	6,586	10,822	15,237

Source : Company, Anand Rathi Research

Fig 14 – RoE, RoCE analysis

Year-end 31 Dec	FY08	FY09	FY10e	FY11e	FY12e
EBIT / Sales (%)	14.9	18.9	21.6	21.2	21.0
Sales / Average CE (x)	1.2	1.0	0.8	0.8	0.9
EBIT / Average CE (RoCE) (%)	17.4	19.1	18.0	17.6	18.0
Average CE / Average Equity (x)	1.0	1.0	1.0	1.0	1.0
PBT / EBIT (x)	1.0	1.0	1.0	1.0	1.0
PAT / PBT (x)	1.0	1.0	0.8	0.7	0.7
Consolidated PAT / PAT (x)	1.0	1.0	1.0	1.0	1.0
PAT / Average Equity (RoE) (%)	16.7	18.3	14.6	13.2	13.0

Source : Company, Anand Rathi Research

Fig 15 – Key ratios @ Rs535

Year-end 31 Dec	FY08	FY09	FY10e	FY11e	FY12e
Diluted shares (m)	138	129	130	131	133
FDEPS (Rs)	33.0	44.3	42.1	43.1	47.6
CEPS (Rs)	38.7	50.4	47.7	48.9	53.8
BV (Rs)	201.3	268.4	309.0	347.1	388.6
P/E (x)	16.2	12.1	12.7	12.4	11.2
P/C (x)	13.8	10.6	11.2	10.9	10.0
P/B (x)	2.7	2.0	1.7	1.5	1.4
EV/Sales (x)	2.1	2.1	2.0	1.6	1.3
EV/EBITDA (x)	13.1	10.9	9.9	8.1	6.5
Net gearing (%)	(53.5)	(58.8)	(61.0)	(65.0)	(68.6)
Working capital turnover (days)	12.3	38.2	55.6	56.5	57.5
DPS (Rs)	3.0	3.0	3.0	3.5	4.0
Dividend payout (%)	9.9	7.9	8.3	9.5	9.8
Dividend yield (%)	0.6	0.6	0.6	0.7	0.7

Source : Bloomberg, Company, Anand Rathi Research

Patni's fact sheet

Period (Dec-end)	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10
Revenue breakup (geographical, %)						
Americas	78.6	78.9	80.0	80.8	80.5	79.7
EMEA	15.6	15.1	14.2	13.5	14.0	13.4
APAC	5.8	6.0	5.8	5.7	5.5	6.9
Total	100.0	100.0	100.0	100.0	100.0	100.0
Revenue breakup (industry verticals, %)						
Insurance	27.1	27.3	29.7	31.2	30.5	29.0
Manufacturing, Retail & Distribution	28.8	29.2	27.7	28.4	30.3	30.8
Financial Services	12.9	13.7	13.8	12.3	12.0	11.7
Communications, Media & Utilities	15.5	14.4	13.7	13.5	12.3	12.2
Product Engineering Services	15.7	15.4	15.1	14.6	14.9	16.3
Total	100.0	100.0	100.0	100.0	100.0	100.0
Revenue breakup (service offerings, %)						
Application development & maintenance	64.6	65.1	64.9	65.0	65.8	64.6
Package software implementation	13.5	13.7	13.8	12.9	12.8	13.4
Product engineering services	11.3	11.4	11.3	11.1	11.2	12.1
Infrastructure management services	5.0	3.5	4.7	6.0	5.3	5.0
Business process outsourcing	5.6	6.3	5.3	5.0	4.9	4.9
Total	100.0	100.0	100.0	100.0	100.0	100.0
Revenue (project type, %)						
T&M	62.2	62.4	60.2	57.6	57.6	56.4
Fixed price projects (incl. fixed priced SLA)	37.8	37.6	39.8	42.4	42.4	43.6
Total	100.0	100.0	100.0	100.0	100.0	100.0
Client details						
Top client (%)	11.0	12.3	12.3	11.9	11.1	11.7
Top 5 clients (%)	34.6	33.7	37.2	38.3	37.0	36.4
Top 10 clients (%)	48.7	46.8	50.1	51.4	50.9	48.7
USD\$1m (Nos.)	92	94	90	92	92	92
USD\$5m (Nos.)	30	26	26	27	26	27
USD\$10m (Nos.)	19	20	17	16	15	16
USD\$50m (Nos.)	2	2	2	2	2	3
New clients (Nos.)	18	22	7	7	20	9
Active clients (Nos.)	331	320	294	283	272	260
Repeat business (%)	93.1	94.1	94.5	93.6	93.7	92.5
Revenue mix & Utilization (%)						
Efforts – onsite	28.7	28.3	27.6	26.8	26.9	25.2
Efforts – offshore	71.3	71.7	72.4	73.2	73.1	74.8
Revenue – onsite	58.6	57.8	55.5	55.1	54.9	53.2
Revenue – offshore	41.4	42.2	44.5	44.9	45.1	46.8
Utilization	73.1	70.3	74.4	77.0	77.4	79.9
Employee details						
Offshore	11,928	11,693	11,022	10,843	11,264	11,118
Onsite	2,966	2,847	2,758	2,764	2,731	2,841
Total employees	14,894	14,540	13,780	13,607	13,995	13,959
Sales & support	1,563	1,550	1,495	1,520	1,484	1,415
Net additions	193	(354)	(760)	(173)	388	(36)
Attrition (LTM) excluding BPO (%)	18.6	15.5	13.2	11.3	13.7	17.7

Source: Company Reports

Appendix 1

Analyst Certification

The views expressed in this research report accurately reflect the personal views of the analyst(s) about the subject securities or issuers and no part of the compensation of the research analyst(s) was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst(s) in this report.

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Rating and Target Price History (as of 29 April 2010)



Source: Bloomberg

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Ratings Guide

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