

BHARAT HEAVY ELECTRICALS

Steady against all odds; pace of recovery key

India Equity Research | Engineering and Capital Goods

We had upgraded BHEL to 'BUY' in July 2016 anchored by a few positive triggers on the horizon. Of these, thermal ordering/demand has not picked up materially, which remains a key monitorable. On the positive side though, the company's executable order book (OB) has jumped to 78% (54% last year) in H1FY18 as execution of slow-moving orders has gathered pace and gross margin has improved to ~40%. Consequently, FY19/20 earnings visibility has improved along with potential for further improvement in working capital as thermal projects gather momentum. Maintain 'BUY' with DCF-based revised TP of INR110 (earlier INR115, implying FY19E PE at 23x) given reasonable working capital improvement potential and a medium-term revival in thermal demand from current 6-8GW p.a.

L1 positions translating, improving revenue visibility

On perusing BHEL's L1 positions, we expect projects worth ~INR250bn to be awarded by Mar'18 end (refer table 2). Consequently, BHEL's OB would increase to ~INR1.1trn (3.8x TTM revenues). Lift irrigation projects, rolling stock and Sox Nox ordering could further add to the closing OB. Movement in standstill orders (Ennore and Yadadari) in past 1 year and translation of L1 position, will drive 11% revenue CAGR over next 2-3 years.

Gradual dip in WC requirement, margins to perk up

Ballooning debtors (from ~300 days in FY13 to 480 days in FY16) had kept investors on tenterhooks. We believe the debtor recovery witnessed in FY17 to continue going forward, despite minor GST-led impact in 1HFY18. While volatility in P&L is seen due to provision/reversal of liquidation damages, in our view, BHEL's strong track record (mere 2% of projects have faced liquidation damage charges till date) and exclusion of JDU clause for the new projects are likely to cushion OPM, albeit bigger delta will depend on extent of ramp up.

Outlook & Valuations: Recovery over medium term; maintain BUY

We note that the government's thrust on renewables was the key negative for BHEL in past 1 year. However, we believe, such transition will be slower and tendering for conventional energy would range in 10-12GW (including replacement) in foreseeable future, where BHEL commands significant market share (~65%). We maintain 'BUY/SP'.

EDELWEISS 4D RATINGS

Absolute Rating	BUY
Rating Relative to Sector	Performer
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Overweight

MARKET DATA (R: BHEL.BO, B: BHEL IN)

CMP	: INR 90
Target Price	: INR 110
52-week range (INR)	: 122 / 77
Share in issue (mn)	: 3,671.4
M cap (INR bn/USD mn)	: 332 / 5,138
Avg. Daily Vol.BSE/NSE('000)	: 9,807.0

SHARE HOLDING PATTERN (%)

	Current	Q1FY18	Q4FY17
Promoters *	63.1	63.1	63.1
MF's, FI's & BK's	17.3	16.6	16.4
FII's	14.3	15.8	15.9
Others	5.4	4.5	4.6
* Promoters pledged shares (% of share in issue)	:	NIL	

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Capital Goods Index
1 month	(9.9)	(3.2)	(2.0)
3 months	3.0	1.7	5.1
12 months	5.1	24.5	31.9

Amit Mahawar
 +91 22 4040 7451
 amit.mahawar@edelweissfin.com

Swarnim Maheshwari
 +91 22 4040 7418
 swarnim.maheshwari@edelweissfin.com

Ashutosh Mehta
 +91 22 2286 2748
 ashutosh.mehta@edelweissfin.com

Darshika Khemka
 +91 22 4063 5544
 darshika.khemka@edelweissfin.com

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Financials






(INR mn)

Year to March	FY16	FY17E	FY18E	FY19E
Revenues	254,831	282,222	292,202	346,271
EBITDA	(13,662)	11,009	13,572	23,886
Adjusted Profit	(7,091)	4,959	9,854	16,761
Adjusted diluted EPS (INR)	(1.9)	1.4	2.7	4.6
Diluted P/E (x)	(46.8)	66.9	33.6	19.8
EV/EBITDA (x)	(17.0)	20.7	15.4	7.6
ROAE (%)	(2.1)	1.5	3.0	5.1

What's on track and what's behind?

Post our upgrade to 'BUY' in July'16 from 'HOLD' (refer our note, "[Breaking shackles of extreme pessimism](#)"), the stock had hit a high of INR119 (bonus adjusted). While we remain positive on BHEL, here we appraise our thesis with actual performance (from report date to-date). We round up the performance on various parameters till date here below.

Table 1: Appraisal of key parameters

Parameter	Appraise	Remarks
Gross margin improvement		Gross margin improved from ~35% in Q2FY16 visible to ~40% in 1HFY18 and we believe the same to sustain going ahead.
Pick up in equipment ordering by FY19		With government push for renewables, ordering has not picked up as against our initial assessment.
Reduction in Debtors		Debtors have reduced from INR 335bn in FY16 to INR 319bn in FY17. While a minor uptick was witnessed on back of GST disruption to INR 330bn, we expect debtor reduction to continue.
16GW sustainable tendering annually		With government push for renewables, the 16GW annual tendering seems difficult
38 GW net capacity addition over FY17-22		Apart from 50 GW coal capacity under construction, capacity expansion of 22 GW is planned over FY17-22 from conventional sources.

Source: Company, CEA, Edelweiss research

Notwithstanding the government's thrust on renewables, we maintain that capacity addition under conventional sources will continue as the shift to renewables would be comparatively slower. While we had not anticipated a drastic shift in slow-moving orders, gathering momentum in execution of these orders will drive revenue growth over FY17-20E. Further, we believe even amid intensifying competition and lack of orders, OPM would stabilise at current levels of 40%, and acceleration in execution would absorb impact of the Seventh Pay Commission.

Sox Nox compliance to expand target market:

NTPC has floated tenders for installation of Flue gas desulphurisation (FGD) for 17 GW of thermal power plants to ensure compliance with Sox norms. Of this ~13 GW of power plants are under construction. With the price ranging from INR 3.5-4mn/MW for FGD, this would translate into a target market potential of ~INR 50-60bn. Additional tenders for installation of FGD and potential for installation of selective catalytic reduction (SRC) to comply with Nox emission norms could act as further triggers to the new emerging market.

Award of BHEL L1 projects worth INR 220-250bn looks feasible

Status assessment of the projects in which BHEL is L1 suggests the projects would likely be awarded by Mar'18. This would result in closing order book of INR1.1trn by Mar'18. Apart from the power projects, the upcoming lift irrigation projects in Andhra Pradesh and Telangana and rolling stock orders could provide additional uptick to BHEL's order book.

Table 2: L1 project status

Project	MW	INR bn	TOR	Environmental clearance
Patratu NTPC	3 * 800	120	Jun-16	Nov-17
Bhusawal Mahagenco	1 * 660	30	Jan-14	Pending
Pankhi UPRVNL	1 * 660	30	Sep-14	Jun-17
Udangudi Tangedco	2 * 660	75	Nov-15	Pending
Total	5,040	255		

Source: Company, Industry, Edelweiss research

Table 3: Projects likely in the medium term

Project	MW	Remarks
NTPC Khargaon	2 * 660	Environmental clearance received on Mar-15
THDC Khurga project	2 * 660	Environmental clearance received in Mar-17
Adani Godda	2 * 800	Environmental Impact Assessment submitted in Apr-17. EC awaited.
WBPDCL Sagardighi	1 * 660	Project has received financial closure
Adani Udupi	2 * 800	Land acquisition underway
NPCIL Gorakhpur	2 * 700	Tender floated
NTPC Singrauli	2 * 660	Tender floated
NTPC Talchar	2 * 660	Commissioning target by FY21
Total	10,540	

Source: Company, Industry, Edelweiss research

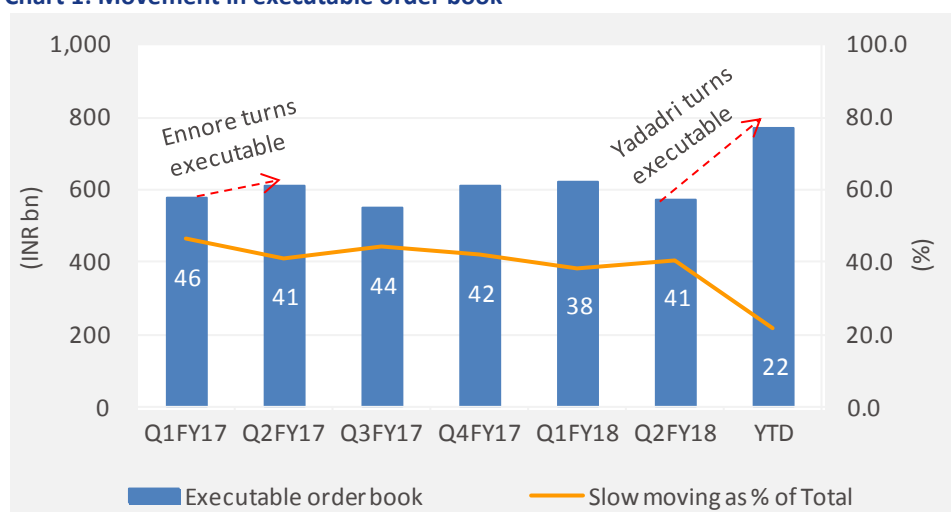
Break up of slow moving order book

Project	Value (INR bn)
Lataatapovan,	
Shahpurgandi & Edlapur	72
Export (Syria and Yemen)	32
Private	111
Monnet and India bulls	60
Other private	51
Total	215

Reduction in slow-moving OB improves FY19/20E visibility:

Post TANGENCO's win in Supreme Court against Trishe, execution resumed at the INR76bn Ennore power plant. Yadadri (INR204bn), another slow-moving large order, received environmental clearance in Oct'17. Consequently slow moving OB as a % of total OB, reduced from 46% in FY16 to 22% in 2HFY18.

Chart 1: Movement in executable order book

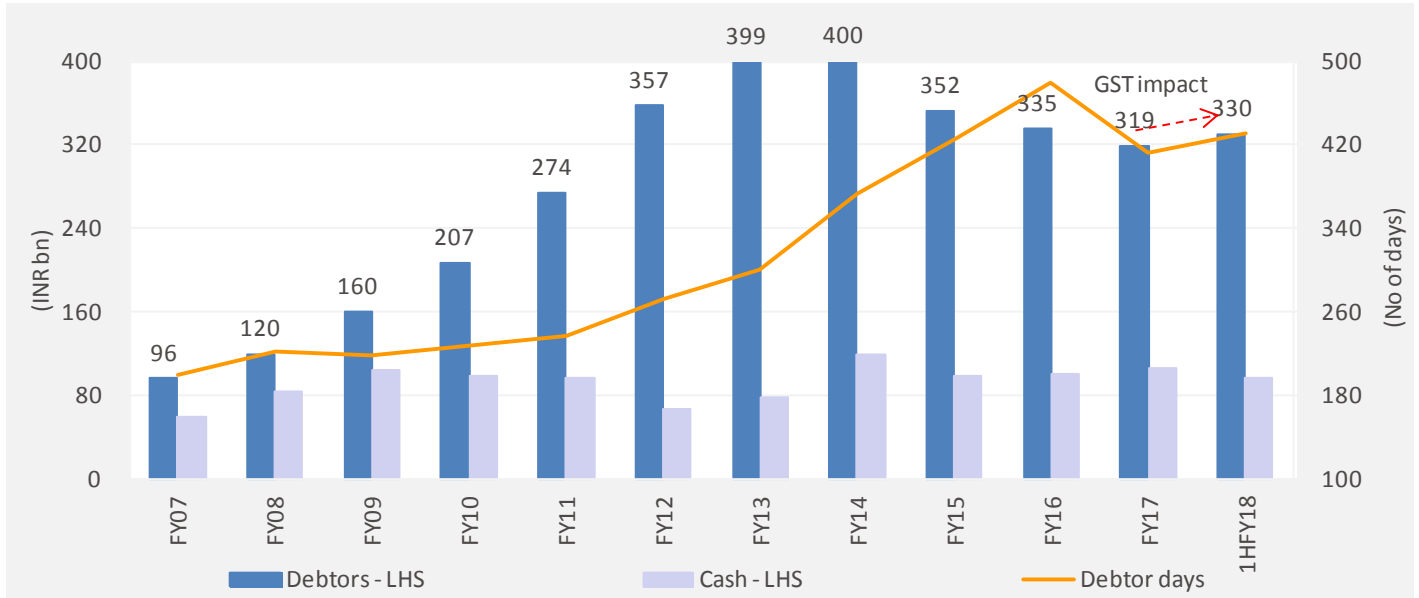


Source: Company, Edelweiss research

Debtor recovery witnesses temporary blip, improvement on the cards

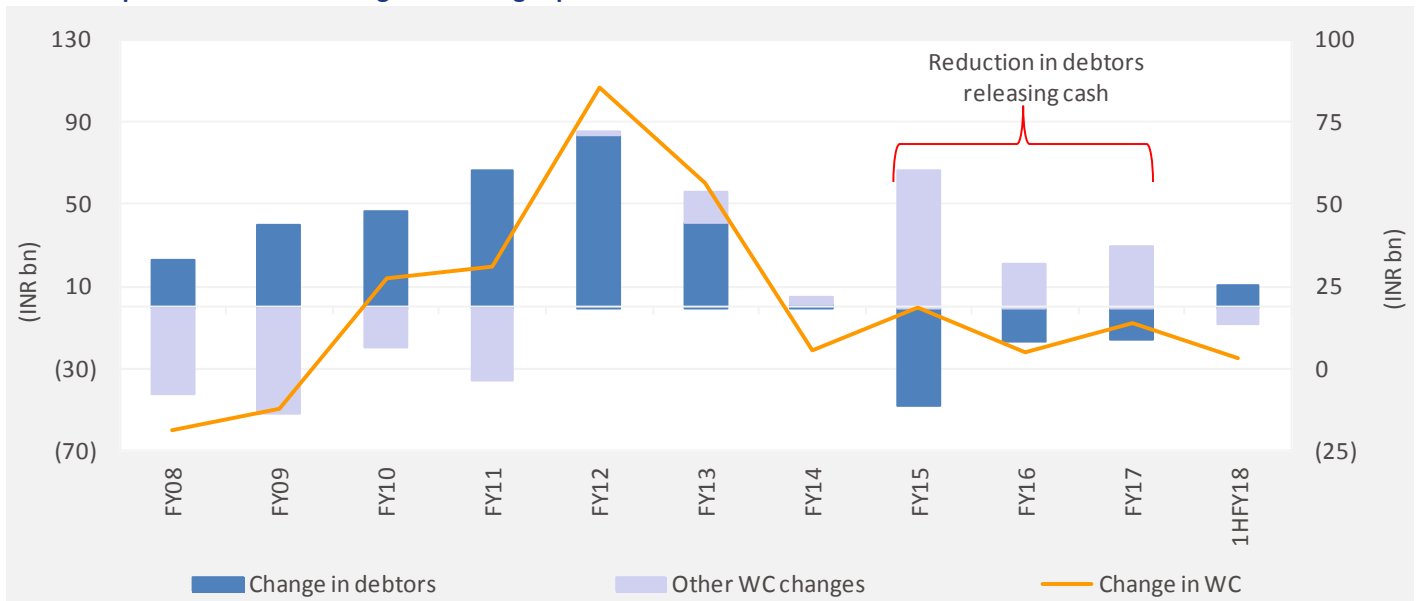
BHEL's sharpened focus on book debts recovery aided some recovery in FY17, which saw a temporary disruption in H1FY18 around the GST quarter. With an improving outlook on execution (Gol's focus on thermal project execution and recent uptick in BHEL's executable OB), we believe BHEL is well poised to see its debtor recovery cycle resuming and in turn favourably impacting WC and assuaging one of the key investor concerns.

Chart 2: Movement in debtors, debtor days



Source: Company, Edelweiss research

Chart 3: Impact of Debtors on change in working capital



Source: Company, Edelweiss research

Valuation and Outlook: On a steady recovery course

In July'16 we had upgraded BHEL based on: a) Strong potential improvement in WC, driving cash flows; b) Provision reversals (mostly private) done with; and c) Gradual recovery prospects in thermal. While WC recovery and pick up in execution was witnessed to some extent, pick up in ordering has yet to play out and may not happen in a hurry given weak power demand/slow traction by state GENCOs. However, we maintain our stance of strong execution leg up which seems reasonable post the recent improvement in executable OB - this makes FY19/20E P/L improvement imminent, especially given a stable gross margin profile.

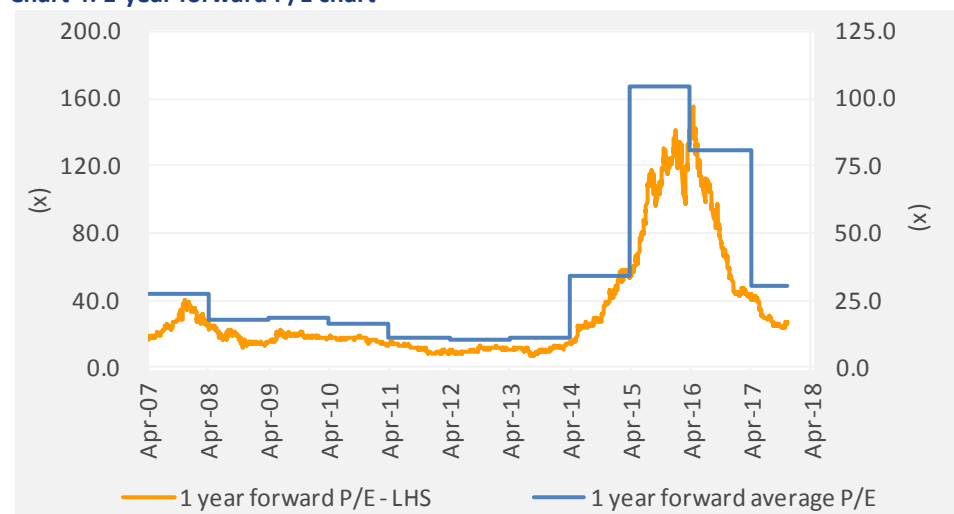
As we cut our BTG market assumptions to factor in government's thrust on renewables, our revised DCF-based TP is INR110 (INR115 earlier). Our valuation assumes revenue CAGR of 10% over FY17-25 and pick up in margins following elimination of the Joint Deed of Undertaking (JDU) clause. With risk free rate of 7% and beta of 1.52x (as per Bloomberg), WACC stands at 14%.

Table 4: DCF valuation and key assumptions

Particulars	(INR mn)
PV of Cash Flows over FY19-25	133,009
Terminal Value	166,255
Total Value of firm	299,264
Add: Net Cash	104,022
Total Equity Value	403,287
No. Of O/S shares (mn)	3,671
Value Per Share (INR /Share)	110
Particulars (%)	
Cost of Equity (Beta @ 1.52)	14.1
Debt/Equity (x)	-
WACC	14.1
Tax rate	33.0
Terminal Growth rate	5

Source: Bloomberg, Company, Edelweiss research

Chart 4: 1-year forward P/E chart



Source: Bloomberg, Edelweiss research

Company Description

BHEL is the largest heavy engineering and manufacturing enterprise in India in the energy-related/infrastructure sector. It manufactures over 180 products under 30 major product groups and caters to core sectors of the Indian economy viz., power generation & transmission, industry, transportation, telecommunications, and renewable energy. The company has a wide network with 14 manufacturing divisions, four power sector regional centers, over 100 project sites, eight service centers, and 18 regional offices across the country. An extensive network enables the company promptly serve its customers and provide them with suitable products, systems, and services. The company derives major revenues from power equipment manufacturing including boiler, turbine generators, major auxiliaries etc with more than 65 % of the total component manufacturing in house.

Investment Theme

1) Historically, power equipment ordering was driven by dual catalysts of >70% jump in PLFs and expectations of improvement in discoms' health. Anchored by our assumption of uptick in power demand, we anticipate pick in equipment ordering by FY19 versus consensus expectation by FY22 or beyond; 2) Our detailed proprietary work reveals the following: (a) BHEL may have to make additional provision of INR15-20bn for private IPP projects. Bulk of this was recognised in past 4 years; (b) Major chunk (~50%) of current receivables is from government companies, which at the most entail liquidated damages risk, but nil credit risk; (c) Despite optically highest NWC/sales ratio in our coverage universe, BHEL's cash levels are at historic highs and rising, suggesting that the pain from debtors is now receding; and 3) Our detailed risk-reward analysis indicates potential 30-85% upside (even assuming sedate sector outlook) with downside risk of mere 10-15%, a clear proof that the odds are in our favour.

Key Risks

- 1) Few projects like Abhijeet/Visa Power completely gone down and BHEL has to infuse additional equity to commence the project.
- 2) Few quarters of low profitability.

Financial Statements

Key Assumptions

Year to March	FY16	FY17	FY18E	FY19E
Macro				
GDP(Y-o-Y %)	7.9	6.6	6.5	7.1
Inflation (Avg)	4.9	4.5	4.0	4.5
Repo rate (exit rate)	6.8	6.3	5.8	5.8
USD/INR (Avg)	65.5	67.1	65.0	66.0
Sector				
Total ordering (In Gw)	13.0	8.0	8.0	10.0
BHEL market share asmpn	65.0	65.0	65.0	70.0
Company				
Total OI (INR mn)	439	235	242	328
Power (Inr bn)	385	173	177	250
Industry(Inr bn)	53	62	65	78
Power rev growth (%)	(13.6)	10.0	7.0	19.3
Industry rev growth (%)	(15.7)	3.0	(8.2)	15.1
Capex (INR mn)	5,506	3,359	5,550	5,550
Dep. (% gross block)	7.6	6.5	5.9	6.0

Income statement

(INR mn)

Year to March	FY16	FY17	FY18E	FY19E
Income from operations	254,831	282,222	292,202	346,271
Direct costs	161,188	171,100	175,533	207,795
Employee costs	53,798	53,999	63,204	67,028
Other Expenses	53,507	46,114	39,893	47,562
Total operating expenses	268,493	271,213	278,630	322,385
EBITDA	(13,662)	11,009	13,572	23,886
Depreciation	9,357	8,488	8,559	9,030
EBIT	(23,019)	2,520	5,014	14,856
Add: Other income	14,977	7,264	11,251	12,269
Less: Interest Expense	3,595	3,506	2,766	3,182
Profit Before Tax	(11,637)	6,278	13,499	23,944
Less: Provision for Tax	(4,546)	1,320	3,645	7,183
Reported Profit	(7,091)	4,959	9,854	16,761
Adjusted Profit	(7,091)	4,959	9,854	16,761
Shares o /s (mn)	3,671	3,671	3,671	3,671
Adjusted Basic EPS	(1.9)	1.4	2.7	4.6
Diluted shares o/s (mn)	3,671	3,671	3,671	3,671
Adjusted Diluted EPS	(1.9)	1.4	2.7	4.6
Adjusted Cash EPS	(1.7)	3.2	5.0	7.0
Dividend per share (DPS)	0.4	1.6	1.3	2.0
Dividend Payout Ratio(%)	(18.8)	90.6	56.3	50.9

Common size metrics

Year to March	FY16	FY17	FY18E	FY19E
Operating expenses	105.4	96.1	95.4	93.1
EBITDA margins	(5.4)	3.9	4.6	6.9
EBIT margins	(9.0)	0.9	1.7	4.3
Net Profit margins	(2.8)	1.8	3.4	4.8

Growth ratios (%)

Year to March	FY16	FY17	FY18E	FY19E
Revenues	(15.7)	10.7	3.5	18.5
EBITDA	(165.1)	(180.6)	23.3	76.0
Adjusted Profit	(149.6)	(169.9)	98.7	70.1

Engineering and Capital Goods

Balance sheet		(INR mn)			
As on 31st March	FY16	FY17	FY18E	FY19E	
Share capital	4,895	4,895	7,343	7,343	
Reserves & Surplus	316,916	318,049	319,909	328,136	
Shareholders' funds	321,811	322,944	327,252	335,478	
Short term borrowings	-	-	1,500	3,000	
Long term borrowings	1,263	896	849	1,349	
Total Borrowings	1,263	896	2,349	4,349	
Long Term Liabilities	113,858	80,894	80,894	80,894	
Def. Tax Liability (net)	(42,422)	(47,145)	(47,145)	(47,145)	
Sources of funds	394,510	357,590	363,350	373,577	
Gross Block	127,615	132,763	137,663	142,563	
Net Block	38,251	34,911	31,688	28,035	
Capital work in progress	3,095	1,595	1,745	1,895	
Intangible Assets	1,457	1,136	1,199	1,223	
Total Fixed Assets	42,803	37,641	34,633	31,152	
Non current investments	6,642	6,614	6,614	6,614	
Cash and Equivalents	100,860	104,918	125,011	153,364	
Inventories	96,022	73,724	76,946	85,395	
Sundry Debtors	335,574	318,633	287,084	291,605	
Loans & Advances	2,422	2,169	2,299	2,345	
Other Current Assets	24,885	21,457	26,607	29,268	
Current Assets (ex cash)	458,903	415,983	392,936	408,613	
Sundry creditors	94,446	93,403	91,373	102,474	
Other Current Liab	120,252	114,165	104,472	123,693	
Total Current Liab	214,698	207,568	195,845	226,167	
Net Curr Assets-ex cash	244,204	208,414	197,090	182,446	
Uses of funds	394,510	357,590	363,350	373,577	
BVPS (INR)	87.7	88.0	89.1	91.4	

Free cash flow		(INR mn)			
Year to March	FY16	FY17	FY18E	FY19E	
Reported Profit	(7,091)	4,959	9,854	16,761	
Add: Depreciation	9,357	8,488	8,559	9,030	
Interest (Net of Tax)	2,191	2,651	2,019	2,227	
Others	3,678	3,417	747	954	
Less: Changes in WC	4,693	13,895	(11,324)	(14,645)	
Operating cash flow	3,442	5,620	32,503	43,618	
Less: Capex	5,506	3,359	5,550	5,550	
Free Cash Flow	(2,064)	2,262	26,953	38,068	

Peer comparison valuation

Name	Market cap (USD mn)	Diluted P/E (X)		P/B (X)		ROAE (%)	
		FY18E	FY19E	FY18E	FY19E	FY18E	FY19E
Bharat Heavy Electricals	5,138	33.6	19.8	1.0	1.0	3.0	5.1
Larsen & Toubro	26,317	23.9	21.2	3.0	2.8	13.3	13.6
Thermax	2,018	40.9	32.4	4.6	4.1	10.9	12.5
Median	-	33.6	21.2	3.0	2.8	10.9	12.5
AVERAGE	-	32.8	24.5	2.9	2.6	9.1	10.4

Source: Edelweiss research

Cash flow metrics		FY16	FY17	FY18E	FY19E
Year to March					
Operating cash flow		3,442	5,620	32,503	43,618
Investing cash flow		529	3,136	(5,550)	(5,550)
Financing cash flow		(1,238)	(4,699)	(6,313)	(9,715)
Net cash Flow		2,734	4,058	20,640	28,352
Capex		(5,506)	(3,359)	(5,550)	(5,550)
Dividend paid		(1,830)	(3,537)	(5,547)	(8,534)

Profitability and efficiency ratios

Year to March	FY16	FY17	FY18E	FY19E
ROAE (%)	(2.1)	1.5	3.0	5.1
ROACE (%)	(2.4)	3.0	5.0	8.1
Inventory Days	223	181	157	143
Debtors Days	510	423	378	305
Payable Days	207	200	192	170
Cash Conversion Cycle	526	404	343	277
Current Ratio	2.6	2.5	2.6	2.5
Gross Debt/Equity	-	-	-	-
Adjusted Debt/Equity	-	-	-	-
Interest Coverage Ratio	(6.4)	0.7	1.8	4.7

Operating ratios

Year to March	FY16	FY17	FY18E	FY19E
Total Asset Turnover	0.6	0.8	0.8	0.9
Fixed Asset Turnover	6.3	7.5	8.5	11.1
Equity Turnover	0.8	0.9	0.9	1.0

Valuation parameters

Year to March	FY16	FY17	FY18E	FY19E
Adj. Diluted EPS (INR)	(1.9)	1.4	2.7	4.6
Y-o-Y growth (%)	(150.0)	169.9	98.7	70.1
Adjusted Cash EPS (INR)	(1.7)	3.2	5.0	7.0
Diluted P/E (x)	(46.8)	66.9	33.6	19.8
P/B (x)	1.0	1.0	1.0	1.0
EV / Sales (x)	0.9	0.8	0.7	0.5
EV / EBITDA (x)	(17.0)	20.7	15.4	7.6
Dividend Yield (%)	0.4	1.7	1.4	2.2

Additional Data

Directors Data

Atul Sobti	CMD	D Bandyopadhyay	Director - HR
Amitabh Matuhur	Director (IS&P)	Subrata Biswas	Director (E,R&D)
Akhil Joshi	Director (Power)	Dr. Subhash Chandra Pandey	Part-time Official Director
Bhaskar Jyoti Mahata	Part-time Official Director	Rajesh Kishore	Independent Director
Keshav N Desiraju	Independent Director	R Swaminathan	Independent Director
Ms. Sushma Padhy	Independent Director	Desh Deepak Doel	Independent Director
Ranjit Rae	Independent Director		

Auditors - SN Dhawan & Co

Holding – Top10

	Perc. Holding		Perc. Holding
Government of india	42.04	Life insurance corp	9.54
Comgest s a	2.53	Pinebridge investmen	2.2
Lazard emerging mkt	1.12	Magellan	1.1
Lazard ltd	1	Fmr llc	0.87
Vanguard group	0.87	Blackrock	0.8

**in last one year*

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
No Data Available				

**in last one year*

Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
No Data Available			

**in last one year*

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
ABB India	BUY	SO	L	Bharat Forge	BUY	SO	M
Bharat Heavy Electricals	BUY	SP	M	CG Power and Industrial Solutions	HOLD	SP	M
Cummins India	BUY	SO	L	Engineers India Ltd	BUY	SO	L
Greaves Cotton	HOLD	SP	M	Kalpataru Power	BUY	SO	M
KEC International	BUY	SP	M	Larsen & Toubro	BUY	SO	M
Praj Industries	BUY	None	None	Ramkrishna Forgings	BUY	SP	M
Siemens	HOLD	SP	L	TD Power Systems	HOLD	None	None
Techno Electric & Engineering	BUY	SP	M	Thermax	REDUCE	SP	L
Triveni Turbine	BUY	None	None	VA Tech Wabag	BUY	None	None

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

Edelweiss
Ideas create, values protect



Edelweiss Securities Limited, Edelweiss House, off C.S.T. Road, Kalina, Mumbai – 400 098.

Board: (91-22) 4009 4400, Email: research@edelweissfin.com

Aditya Narain

Head of Research

aditya.narain@edelweissfin.com

Coverage group(s) of stocks by primary analyst(s): Engineering and Capital Goods

ABB India, Bharat Heavy Electricals, Bharat Forge, CG Power and Industrial Solutions, Engineers India Ltd, Greaves Cotton, KEC International, Cummins India, Kalpataru Power, Larsen & Toubro, Praj Industries, Ramkrishna Forgings, Siemens, TD Power Systems, Techno Electric & Engineering, Thermax, Triveni Turbine, VA Tech Wabag

Recent Research

Date	Company	Title	Price (INR)	Recos
28-Nov-17	Voltas	Mapping a bigger game plan; <i>Visit Note</i>	636	Buy
28-Nov-17	Siemens	Muted quarter; private capex revival awaited; <i>Result Update</i>	1,216	Hold
14-Nov-17	Kalpataru Power	In-line performance; bright prospects; <i>Result Update</i>	377	Buy

Distribution of Ratings / Market Cap

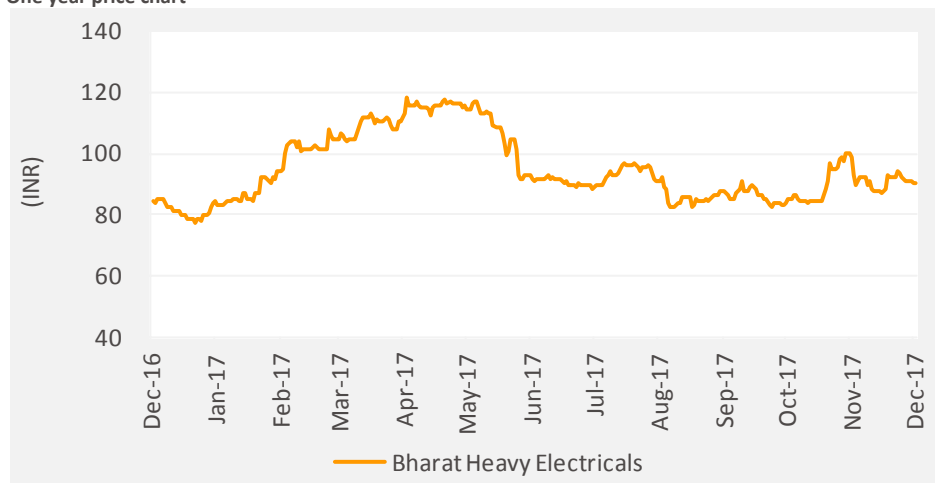
Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	161	67	11	240
* 1stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	156	62	11	

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

One year price chart



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