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Initiating Coverage

IndoStar Capital Finance Ltd.

18-November-2020

RETAIL RESEARCH

IndoStar Capital Finance Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
NBFC	Rs. 295	Buy on dips to Rs.261-265 band and add more on dips to Rs.234-238 band	Rs. 291	Rs. 318	2 quarters

HDFC Scrip Code	INDOSTA
BSE Code	541336
NSE Code	INDOSTAR
Bloomberg	INDOSTAR IN
CMP Nov 17, 2020	295.0
Equity Capital (Rscr)	123.2
Face Value (Rs)	10.0
Eq- Share O/S (cr)	12.3
Market Cap (Rscrs)	3633.9
Book Value (Rs)	290
Avg. 52Wk Volumes	126283
52 Week High	331.2
52 Week Low	166.0

Share holding Pattern % (Sept, 2020)	
Promoters	93.7
Institutions	2.5
Non Institutions	3.8
Total	100.0

Fundamental Research Analyst
Hemanshu Parmar
hemanshu.parmar@hdfcsec.com

Our Take:

IndoStar Capital Finance Ltd (ICFL) has successfully refined its business model in the past couple of years to drive quality growth and produce superior return on equity. The company has established itself as a robust and diversified lending institution in India, and has sharpened its focus on retail lending. The company has strong capital adequacy, a comfortable liquidity position, a resilient operating model and increasing retail mix. The segments it caters to are pivotal in the long-term secular growth trajectory of the Indian financial services sector and are well prepared to capitalise on the opportunity to increase market share. With a strong capital and liquidity position after Brookfield capital infusion, IndoStar Capital Finance Ltd remains well poised to capitalise on favourable industry dynamics and multiple opportunities in play and to grow profitably. ICFL remains optimistic about the growth and outlook of its retail business verticals as the economic environment returns to the new normal of post-pandemic world. The company expects its growth to be driven by its retail business division viz. CV Finance and Affordable Housing Finance followed by SME Finance.

IFCL's strong capitalisation, diversified product offerings and experienced management team partially offset the inherent vulnerability in its current asset quality, given the concentration risks. The segments in which the company operates, especially vehicle financing, SME and real estate, are facing challenges; thus it could be difficult for the company to grow its franchise in near term. The equity capital infusion would however, strengthen its ability to grow its loan book.

Valuations & Recommendation:

ICFL reported sharp improvement in retail collection efficiency in Q2FY21. However degrowth in its wholesale book will drag down its growth in AUM despite healthy capital adequacy ratio. Also ICFL keeps facing asset quality risks in its wholesale book as well as part of its retail book (CV financing, SME Financing). Inorganic growth may help ICFL to scale up its business at one shot. ICFL has restructured 1.4% of its retail book.

Though we remain optimistic on its new promoter strength and high capital adequacy, legacy issues can continue to haunt ICFL for some more time. We think the base case fair value of the stock is Rs.291 (1.05xFY22E ABV) and the bull case fair value is Rs.318 (1.15xFY22E ABV) over the next two quarters. Investors can buy the stock on dips to Rs.261-265 band (0.95xFY22E ABV) and add more on dips to Rs.234-238 band (0.85xFY22E ABV). At the LTP of Rs.295 it quotes at 1.07xFY22E ABV.

Financial Summary (Consolidated)

Particulars (Rs cr)	Q2FY21	Q2FY20	YoY-%	Q1FY21	QoQ-%	FY18	FY19	FY20	FY21E	FY22E
NII	123	167	*-26.4*	134	*-8.5*	438	518	603	668	707
PPoP	51	140	*-63.8*	74	*-31.4*	309	395	384	469	474
PAT	32	49	*-36.0*	47	*-33.1*	200	241	-325	148	240
EPS (Rs)	2.6	5.4	*-52.2*	3.8	*-33.0*	25.5	26.1	-35.1	11.0	17.8
P/E (x)						11.6	11.3	-8.4	26.9	16.5
P/ABV (x)						1.2	1.1	1.3	1.2	1.1
RoAA (%)						3.2	2.5	-3.0	1.5	2.2

(Source: Company, HDFC sec)

FY20 & Q2FY21 Result Review

In fiscal 2020, the company reported loss of Rs 325cr on total income (net of interest) of Rs 736cr. This was because of the higher slippages in the Commercial Vehicle (CV) portfolio due to poor economic environment and also due to spike in provisioning as the company took full amount of the RBI prescribed 10% provision on the moratorium book in Q4 while the RBI has allowed companies to take it over Q4FY20 and Q1FY21. The company has proactively written off these accounts, which led to a sharp decline in profitability in fiscal 2020. The management made contingent Covid-19 related provisions of Rs 280cr in fiscal 2020, in excess of the regulatory requirement, which also impacted profitability in fiscal 2020.

In Q2FY21, the company reported PAT of Rs 31.6cr down 36% YoY on net revenue of Rs 153cr (vs Rs 219.7cr in Q2FY20). Provisions decreased as much as the provisions that were provided for in FY20. AUM de-grew 7.4% QoQ mainly due to fall in corporate loan book. Gross NPAs reduced to 2.9% as on September 30, 2020 from 4.8% as on March 31, 2020 (2.6% as on March 31, 2019), on account of sale of NPAs to ARCs in the first half of fiscal 2021. In the past two years, asset quality had weakened on account of slippages in the wholesale book and owing to the acquired CV book, which already had high NPAs. The company is in advanced stages to recover from the delinquent wholesale account in the current fiscal.

Triggers

Diversified Product Offering:

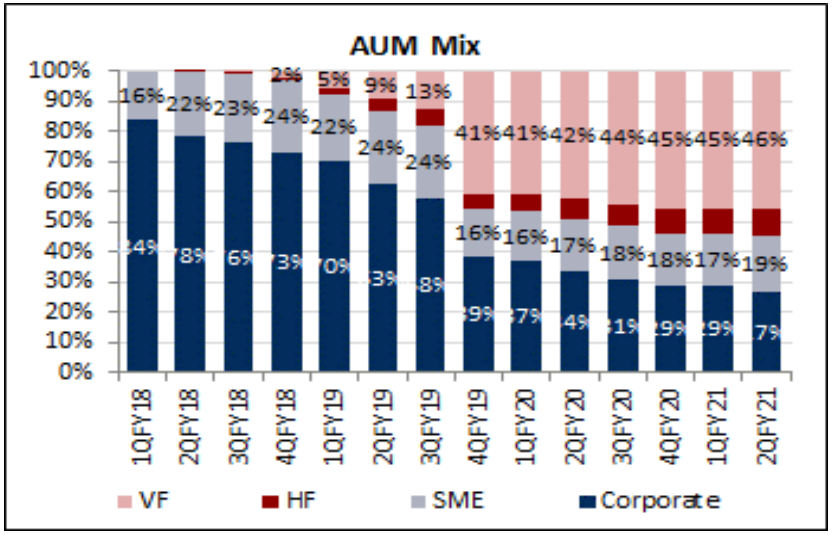
ICFL, with consolidated AUM of Rs 9,084cr as on September 30, 2020 (Rs 9,690cr as on March 31, 2020), has a diversified range of product offerings across retail finance. While the company was earlier a wholesale financier, it has steadily expanded its presence in retail segments in the past few years, and retail loans now constitute the key growth driver.

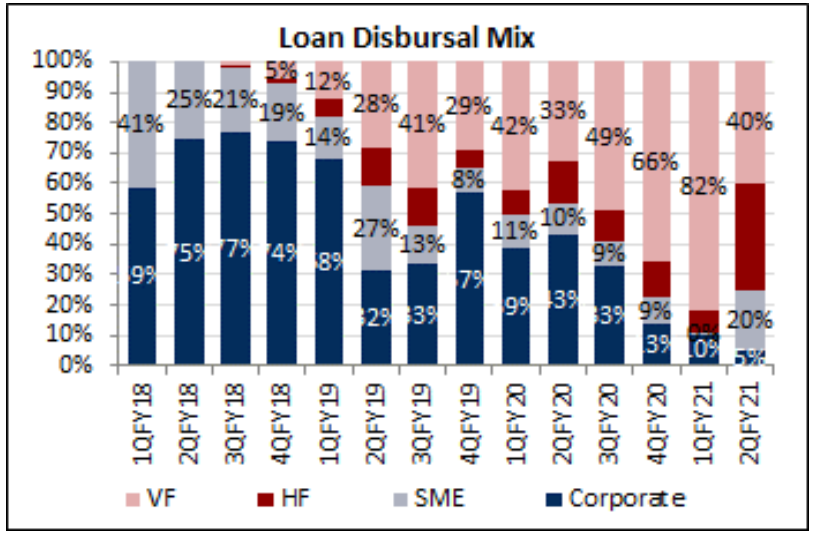
Retail loans stood at Rs 6,862cr as on September 30, 2020 (Rs 7,099cr as on March 31, 2020). The share of retail loans in the overall portfolio has increased to 73% of AUM as on September 30, 2020, from 12% as on March 31, 2017, driven by growth in the retail book and contraction of the wholesale portfolio. Within retail lending, the company is present in CV finance (46% of the AUM), and is more focused on financing purchase of used CVs. Loans to SMEs accounted for 19% of the overall AUM, and mainly comprised secured loans against property. The company has ventured into affordable housing finance (9% of the overall AUM). Going forward, the share of retail AUM is expected to increase further, mainly driven by CV and affordable housing finance. The wholesale portfolio decreased to Rs 2,476cr as on September 30, 2020 (Rs 2,869cr as on March 31, 2020).

Focus on Retail Lending:

The company earlier focused on financing the corporate sector. In 2016, it kickstarted its journey from being a corporate lender to being a diversified, retail-focused NBFC. Since then, ICFL has widened its retail portfolio by increasing its exposure in providing financing for CVs, SMEs, and Housing Segments. The company also saw stress in some whole-sale accounts over the past two years. In line with the retailisation strategy, the management plans to exit the wholesale finance business and focus solely on retail business. Retail book as a percentage of total book has significantly increased to 73% of the assets under management (AUM) as on September 30, 2020, from 37% as on September 30, 2018; partly due to the acquisition of the CV portfolio from IIFL. All its retail lending businesses – Vehicle Finance, Affordable Housing Finance and SME Finance – are profitable.

About 81% of corporate lending portfolio comprises of construction and developer loans, and the remaining is large-ticket corporate loans. However, given the weak macroeconomic environment, primarily for the real estate segment, the management is reducing the book size by encouraging loan sell-down and prepayment. ICFL plans to exit the wholesale finance business in the next 18-24 months.





(Source: Company, HDFC Sec)

Capital Infusion by Brookfield:

The company was founded and incorporated by private equity players (Everstone, Goldman Sachs, Baer Capital Partners, ACPI Investment managers, and CDIB International) with an initial capital of around Rs 900cr. In May 2020, Canada-based alternative asset manager Brookfield Business Partners L.P., through its subsidiary, made an equity capital injection of Rs 1,225cr @Rs.290 per share into ICFL and became the largest shareholder and co-promoter. As on September 30, 2020, Brookfield held 52% stake (acquired @Rs.1870 cr), followed by IndoStar Capital Mauritius (owned by the Everstone group and other marquee private equity investors) at 39% and the Everstone group at 3%. The promoter & promoter group companies' stake increased to 93.74% in the company as on July 10, 2020.

The infusion has led to ICFL having one of the highest capital adequacy ratios (CRAR – 37.7% as on June end) in the listed NBFCs space. Strong liquidity position and low debt-equity positions (2.8x), will aid in further accelerating its retail lending strategy and equips it to use capital to pursue organic and inorganic growth opportunities.

Brookfield is reputed for acquiring high-quality businesses and applying its global investing and operational expertise to create value, with a focus on profitability, as well as sustainable margins and cash flows. It engages itself into businesses that have the potential to benefit from its global expertise, as an owner and operator. Brookfield has supported the existing management team, talent and leadership at IndoStar, which is likely to drive and create value over the next 3-5 years. Brookfield's capital infusion would support organic as well as explore inorganic growth opportunities. Besides equity funding, the investment will also provide access to new debt financing via Brookfield's relationships with various financial institutions.

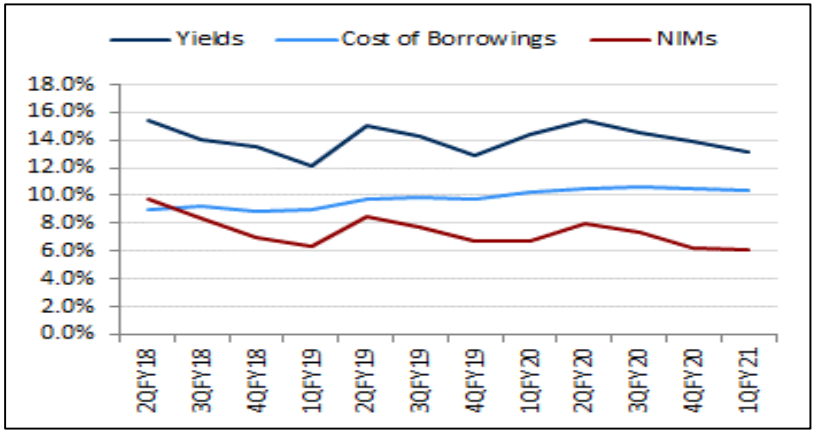
Experienced Management Team:

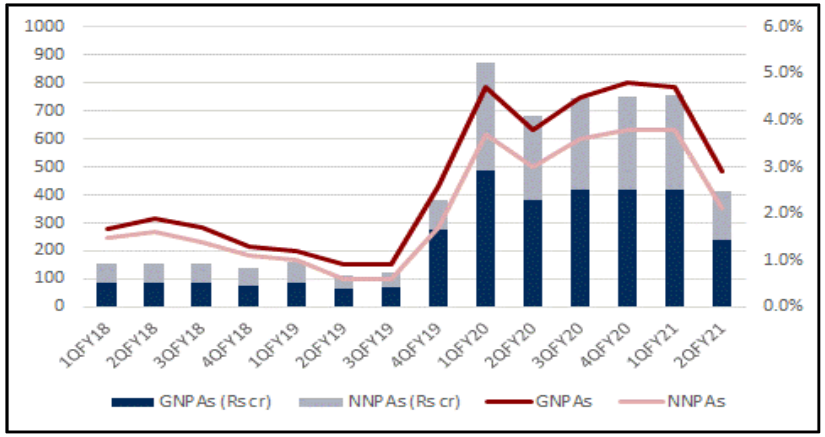
The top management comprises experienced professionals, with proven expertise in retail and wholesale financing, who are expected to help scale up each of the key verticals vehicle, housing and SME finance while maintaining strong underwriting standards. ICFL has management with rich experience in the financial sector. Some of the key management personnel include Mr. R. Sridhar, Executive vice chairman & CEO of ICFL (Former MD and CEO of Shriram Transport Finance Company Ltd.) and Mr. Amol Joshi, CFO (Previously worked with Citicorp, Standard Chartered Bank, has more than 20 years of experience in the financial and corporate sector). Furthermore, the company benefits from the high involvement of the key institutional investors as Brookfield Asset Management has now become the Co-owner with the largest shareholding of 52.3% as on July 2020.

Comfortable Asset Quality:

On the asset quality front, delinquencies had inched up in the past two years especially due to CV portfolio acquired from IIFL and stress in few accounts in the whole sale book. However, gross non-performing assets (NPAs) have reduced in the first half of fiscal 2021 led by sale of NPAs to asset reconstruction companies (ARCs); although, the company will remain invested in the security receipts to the extent of 85% of acquisition price. Gross NPAs and net NPAs reduced to 2.9% and 2.1%, respectively, as on September 30, 2020 (4.8% and 3.8%, respectively, as on March 31, 2020; and 2.6% and 1.7%, respectively, as on March 31, 2019). In addition, the company is in the advanced stages of resolving a large NPA account in the wholesale book. The company plans to run down a substantial portion of the corporate lending book over the next 12 to 18 months to protect its balance sheet from the risks associated and to make the company predominantly a Retail Finance company. The company's ability to scale up the retail loan book while maintaining healthy asset quality will be a key monitorable.

Moreover, the asset quality of CV portfolio continues to remain a key monitorable going forward. On the other hand, the SME segment continues to face adverse impact due to the ongoing lockdown, supply chain disruption, short term demand contraction, stretched debtor cycle and margin pressure. New disbursals are likely to be subdued with uncertainty around demand and assessment of credit quality.





(Source: Company, HDFC Sec)

Strong solvency parameters and strong liquidity position:

The Company is well capitalised to provide adequate capital for its continued growth. As on March 31, 2020, the Capital to Risk Assets Ratio (CRAR) stood at 25.3% (Tier I Capital to Risk Assets Ratio was 20.4% and Tier II Capital to Risk Assets Ratio was 4.8%), well above the regulatory limit of 15% as prescribed by the RBI for NBFCs. Pursuant to investment of approximately Rs 1,225 crore by Brookfield in equity shares and compulsorily convertible preference shares, the CRAR as on Sep 30, 2020 stood at 35%. Leverage has reduced to 2.8x as on Sep 30, 2020 compared to 3.8x a year ago and continues to remain comfortable.

The liquidity position of the company remains strong as it maintains minimum 15% of networth in the form of liquid investments such as fixed deposits and liquid funds, including undrawn bank lines. On a consolidated basis, it had liquidity of Rs 2,582cr (Rs 2,562cr of cash and equivalent and Rs 20cr of unutilised bank lines). Against this, it has debt obligation of Rs 2,421cr through March. As a policy, it avoids an asset-liability mismatch, with the favourable trend of repayment and prepayment cushioning the overall asset-liability management.

Retail Finance - Segments:

Vehicle Financing (VF):

Out of the retail finance segment, the company has substantially increased the proportion of vehicle financing in particular on account of the acquisition of the CV portfolio from IIFL amounting to Rs. 3,514cr (AUM). The seasoning of the VF business originated by ICFL is low however; IIFL's VF portfolio taken over by the company has to some extent higher seasoning. This strategic acquisition has resulted in strengthening of distribution network, particularly in North and West India, and substantial increase in monthly disbursement capacity in vehicle finance business. Post the integration and rationalisation IIFL branches, ICFL's branch network for VF was at 207 with an employee base of 1,532 at Sep 2020.

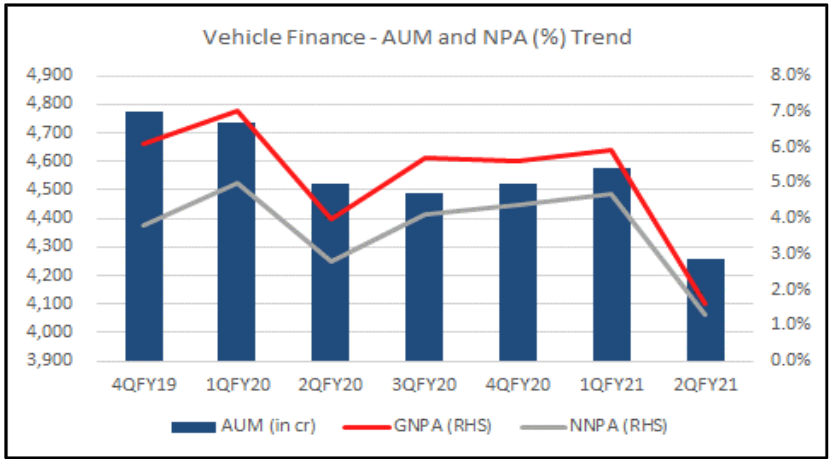
The pre-owned commercial vehicles segment has been the focus area for ICFL's vehicle finance business as the market penetration of organised financing for pre-owned CVs is considerably low, with majority of customers served by private unorganised financiers at higher interest rates. As most of these buyers have nascent banking habits and limited credit history for verification of creditworthiness, the risks associated with pre-owned CV financing are perceived to be high. Used CV financing constitutes more to 50% of the company's vehicle financing AUM as at March end. ICFL is also actively focussed on the small road transport operators (SRTO) segment, while its exposure to fleet operators is only 8% of the CV financing AUM.

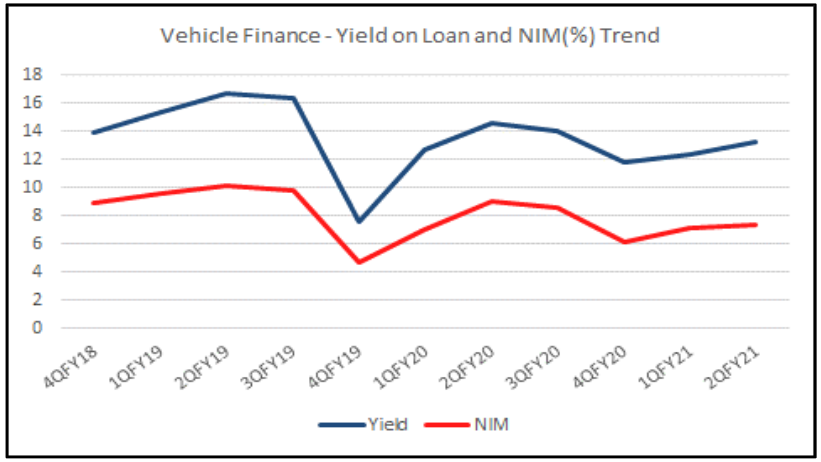
The Company entered into a sourcing, servicing and collection arrangement with ICICI Bank in June 2019, for extending credit to small and medium fleet owners to purchase used and new commercial vehicles across its branch network. Under this partnership, ICFL will originate and serve customers through the entire loan lifecycle right from sourcing to loan servicing for which ICICI Bank will provide funding to these customers. During the period June 2019 to March 2020, Rs 796cr worth of loans were originated on behalf of ICICI Bank.

The VF finance AUM stood at Rs 4,258cr (47% of total loan book) as at Sep-end 2020. The loan book growth of this segment is subdued, given the cyclical nature and regulatory disruptions in this space. Disbursals have not shaped up in a meaningful way. Yields in the VF business are relatively attractive (above 16%) as a result of exposure to used CV financing. In terms of asset quality, the VF business had high NNPAs of 5% as on March-end 2020, which came down to 1.6% as the company off-loaded some NPA accounts to ARC.

The slowdown in the economy prior to the COVID-19-related lockdown, and the resultant idle capacity and fall in freight availability, had already impacted the asset quality of this portfolio. ICFL is primarily into financing of pre-owned commercial vehicles finance space, which

is more vulnerable to such shocks. Macroeconomic headwinds coupled with price hikes due to transition to new emission norms may further dampen consumer demand and financial viability of fleet operators. Market opportunity for NBFCs is likely to come from higher government investments in roads and highways, expected finalisation of the scrappage policy, and greater thrust on rural sector.





(Source: Company, HDFC Sec)

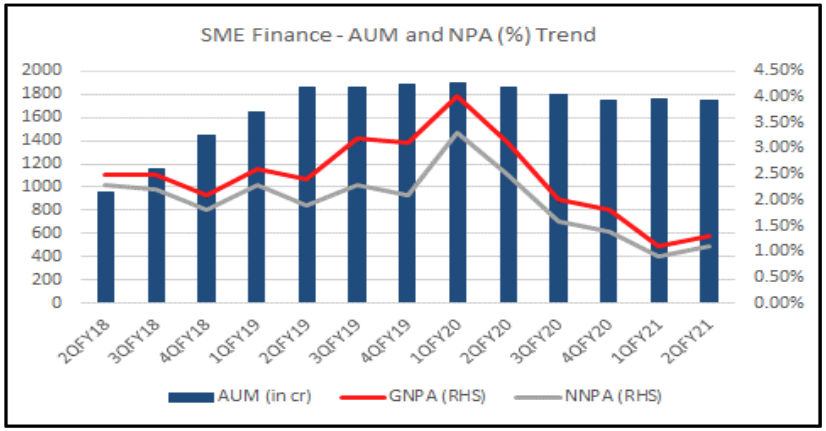
SME Financing:

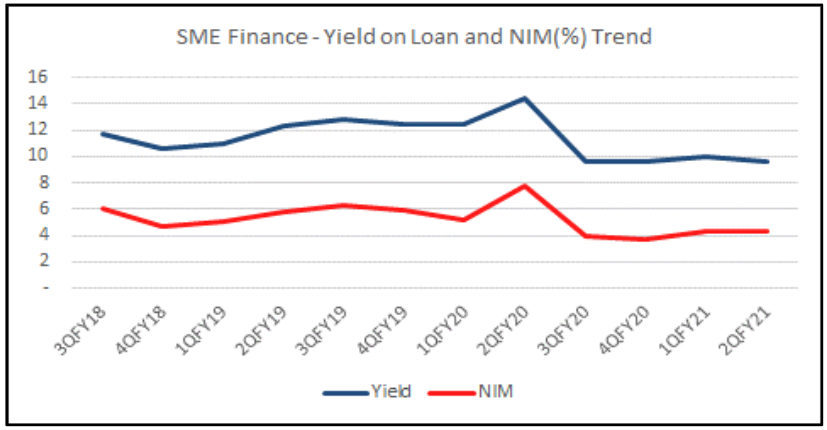
The SME Finance business grew in a calibrated manner, its AUM is Rs 1,749cr, contributing to 19% of its total AUM. Asset quality in this segment continues to be stable, and the company is constantly focussing on deepening its presence in the 10 locations that it operates. Key customers include traders, manufacturers, self-employed professionals and service businesses, with almost 40% of loans disbursed to customers who qualify under the Priority Sector lending (PSL) category.

The growth in the loan book of SME finance slowed down, as the focus shifted to the higher yielding VF and affordable housing finance segments. Various headwinds faced by the sector such as demonetisation, introduction of GST and overall economic slowdown contributed to lower growth of their SME loan book. Yield from this business is ~10% (lower than other retail finance segments). GNPAs stood at 1.3% as at Sep-end which is comforting

The lockdown is expected to result in high impact on collections as most establishments (MSMEs) have faced significant disruption in business. The impact on their cash flows could remain high even after lockdown restrictions are lifted as many of them may grapple not just with how economic activity picks up, but also with business specific supply chain issues and counterparty debtor risk across the value chain.

Notable initiatives by government which includes - setting up of a collateral-free automatic loan provision worth Rs 3 lakh crore for MSMEs in the form of a fully guaranteed emergency credit line; allocation of Rs 20,000cr as subordinate debt facility and a Rs 50,000cr equity infusion for MSMEs through Fund of Funds could alleviate some pressure. The government also revised the definition of MSMEs to include the additional criteria of turnover and eliminate the existing distinction between manufacturing and service units. A company with investments up to Rs 50 crore and turnover up to Rs 250 crore can also be classified as a medium enterprise. Although the asset quality in this segment is stable with LTVs at origination at ~65; given the stress faced by the sector, monitoring of credit quality for next one year will be watched.





(Source: Company, HDFC Sec)

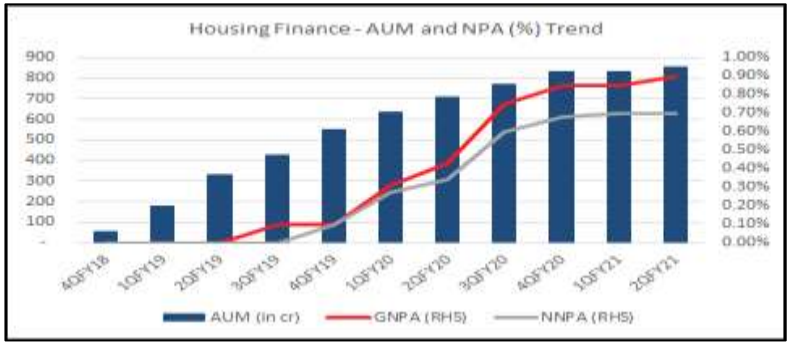
Housing Financing:

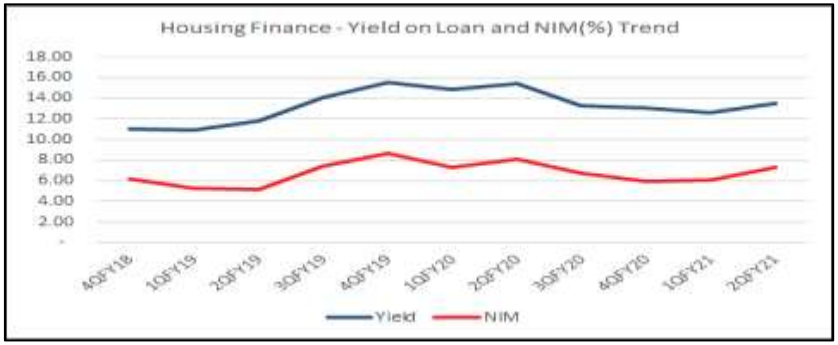
The Housing Finance business at ICFL is operated through its wholly-owned subsidiary IndoStar Home Finance Private Limited. Under this segment, IndoStar provides home loans to self-employed and salaried individuals for purchase and construction of residential properties. The AUM of Housing Finance business grew 52% during FY20 which stood at Rs 831cr. Disbursements during FY20 were at Rs 363cr. This

organically generated portfolio has a strong asset quality and a net NPA of only 0.7%. The company operates in 48 locations across 10 States under this vertical. The Company aims to focus on extending loans to customers situated in Tier II and III cities, as well as the outskirts of urban markets.

Loan book of Housing finance saw sizeable increase over last few quarters. AUM as at Sep end was at Rs 853cr. Yields average ~13%, which are relatively high as a result of focus on particular ticket sizes and geographies. Asset quality in the housing finance portfolio is not a concern at present as GNPAs stood at 0.90%.

Rapid urbanisation, increasing income levels, emerging nuclearisation of families and growing aspirations are the key growth drivers of the housing sector. With the country's mortgage financing being underpenetrated at nearly 10% of GDP, NBFCs and HFCs have taken advantage of this potential and have been the biggest drivers of housing finance growth. The mortgage to GDP ratio for India is expected to grow significantly over the next few years compared to other developing countries. To boost affordable housing and achieve the vision of Housing for All by 2022, the Government has undertaken several initiatives under the Pradhan Mantri Awas Yojana (PMAY) with the aim of building 50 million houses in urban and rural India by 2022.





(Source: Company, HDFC Sec)

Concerns

- Demand for housing assets, consumer goods, micro finance, and working capital finance may remain subdued in the wake of the economic slowdown impacted by COVID-19. This is likely to impact the retail financing industry, one of the key drivers for overall credit growth. A recovery is likely in the second half of FY21 in line with overall economic turnaround.

- The NBFC sector which grappled with liability side disruptions, could see another wave of challenges, this time in the form of asset quality. Amidst these, funding challenges could mount again, as banks become more selective in extending credit. Recent measures announced by the RBI like the Targeted Long Term Repo Operations 2.0 (TLTRO-2) and refinancing from NABARD, SIDBI & NHB could provide some solace to the NBFCs & HFCs, however the sector continues to stare at asset side challenges which are expected to mount going forward.
- The proportion of wholesale loans has decreased, asset quality remains vulnerable to concentration risk despite strong credit appraisal and risk management processes. As on September 30, 2020, the five largest loans accounted for nearly 42% of the wholesale portfolio and 11% of the overall loan portfolio. Furthermore, 81% of the wholesale book comprises real estate loans, a segment vulnerable to cyclical downturns. Greater focus on small-ticket retail loans will support asset quality over the medium term.
- CV financing and SME financing could also raise their own asset quality issues due to the stress on businesses post Covid-19 disruption.
- Promoter shareholding in ICFL is high at ~93%. It needs to bring down this to 75% to comply with public shareholding norms within 1 year from Brookfield infusion. This may lead to dilution and the price at which this is done will be keenly watched.

Company Profile:

IndoStar Capital Finance Ltd (ICFL) is a leading diversified Non- Banking Finance Company (NBFC) registered with the Reserve Bank of India (RBI) as a systemically important non-deposit taking company. The company started its business as a wholesale financier in fiscal 2011, and then entered the SME finance (loan against property) segment in fiscal 2015. In fiscal 2018, the company started offering vehicle finance and housing finance (through wholly-owned subsidiary IndoStar Home Finance Private Ltd). It is now primarily engaged in providing used and new vehicle financing to transporters, housing finance, loans to small and medium enterprise (SME) borrowers as well as structured term financing solutions to corporates. As on Sep 30, 2020, ICFL's loan portfolio stood at Rs.9,084 crore (AUM) of which corporate lending comprised 27% while CV Finance, SME and Housing Finance together accounted for the remaining 73%

The company's focus continues to be to grow disbursements across all the three retail lending segments. As each of these businesses represent a key element for the development of a growing economy. The company has, in the past one year, consolidated branches acquired during the purchase of the CV finance business of IIFL Finance, thereby reducing the overall number of branches. The businesses of commercial vehicle finance, affordable housing finance and SME finance has presence in 18 states spread across 215 branches as on September 30, 2020 (322 branches as on September 30, 2019).

IndoStar Capital Finance Ltd.

INCOME STATEMENT

(Rs cr)	FY18	FY19	FY20	FY21E	FY22E
Interest Income	763	1,081	1,397	1,297	1,323
Interest Expenses	326	564	794	629	616
Net Interest Income	**438**	**518**	**603**	**668**	**707**
Non interest income	26	124	133	131	146
Operating Income	**463**	**642**	**736**	**799**	**853**
Operating Expenses	155	247	352	329	379
PPoP	**309**	**395**	**384**	**469**	**474**
Prov & Cont	-4	16	820	272	153
Profit Before Tax	312	379	-437	197	321
Tax	112	138	-112	50	81
PAT	**200**	**241**	**-325**	**148**	**240**

BALANCE SHEET

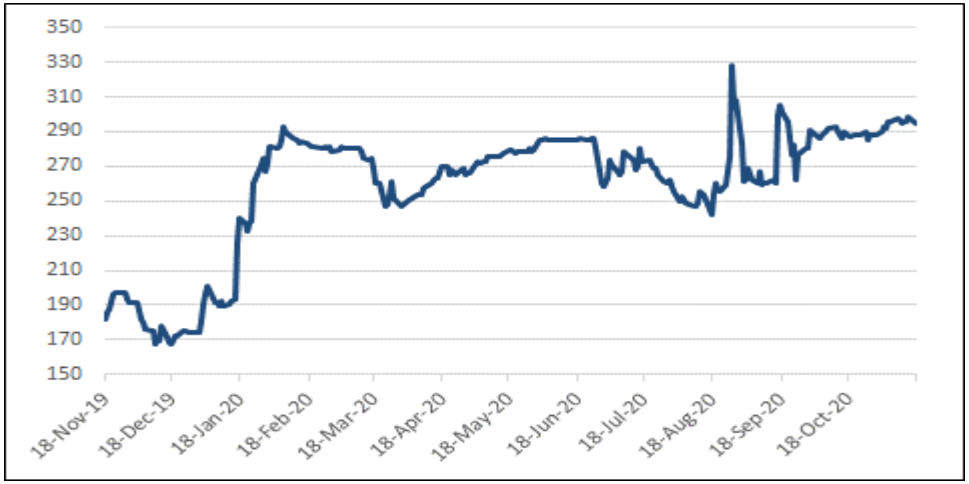
(Rs cr)	FY18	FY19	FY20	FY21E	FY22E
Share Capital	79	92	92	135	135
Reserves & Surplus	1,996	2,914	2,588	3,918	4,159
Shareholder funds	**2,075**	**3,006**	**2,681**	**4,053**	**4,293**
Borrowings	4,823	8,936	6,680	6,033	6,664
Other Liab & Prov.	296	358	277	305	335
SOURCES OF FUNDS	**7,194**	**12,300**	**9,637**	**10,391**	**11,293**
Fixed Assets	64	70	121	127	134
Goodwill on Cons.	0	300	300	300	300
Investment	1,007	301	231	242	266
Cash & Bank Balance	128	1,119	545	2,403	2,552
Advances	5,900	10,364	7,802	6,654	7,350
Other Assets	94	146	638	664	691
TOTAL ASSETS	**7,194**	**12,300**	**9,637**	**10,391**	**11,293**

(Source: Company, HDFC Sec)

RATIO ANALYSIS

As at March (Rs cr)	FY18	FY19	FY20	FY21E	FY22E
Return Ratios (%)					
Calc. Yield on adv	13.3	12.1	12.9	13.8	14.2
Calc. Cost of borr	7.9	8.2	10.2	9.9	9.7
Calc. NIM	7.6	5.8	5.6	7.1	7.6
RoAE	10.2	9.5	-11.4	5.2	5.8
RoAA	3.2	2.5	-3.0	1.5	2.2
Asset Quality Ratios (%)					
GNPA	1.3	2.6	4.6	6.2	5.1
NNPA	1.1	1.4	2.9	3.8	2.8
Growth Ratios (%)					
Advances	18.6	89.1	-15.1	-11.0	10.5
NII	31.9	18.3	16.4	10.8	5.9
PPoP	-8.0	28.1	-3.0	22.3	1.0
PAT	-5.0	20.2	-234.8	-145.5	62.7
Valuation Ratios					
EPS (Rs)	25.5	26.1	-35.1	11.0	17.8
P/E (x)	11.6	11.3	-8.4	26.9	16.5
Adj. BVPS (Rs)	256.1	275.5	226.2	253.7	276.4
P/ABV (x)	1.2	1.1	1.3	1.2	1.1
Dividend per share (Rs)	0.0	1.0	0.0	0.0	0.0
Dividend Yield (%)	0.0	0.3	0.0	0.0	0.0
Other Ratios					
Cost-Income (%)	33	38	48	41	44
Leverage (x)	3.2	3.8	3.9	3.0	2.6

One Year Stock Price Chart



(Source: Company, HDFC sec)

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HDFC securities Limited, I Think Techno Campus, Building - B, "Alpha", Office Floor 8, Near Kanjurmarg Station, Opp. Crompton Greaves, Kanjurmarg (East), Mumbai 400 042 Phone: (022) 3075 3400 Fax: (022) 2496 5066

Compliance Officer: Binkle R. Oza Email: complianceofficer@hdfcsec.com Phone: (022) 3045 3600

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