

Parag Milk Foods Limited

Evolving into a dairy FMCG brand story..

Parag Milk Foods (PARAG) is one of the leading dairy products companies in India. The company has been successful in creating strong brands like **GO, Gowardhan** and in introducing new products like **Whey Protein**. It has become the **2nd player in processed cheese (after Amul)** in a short span of 10 years and commands **33% market share**. Rising revenue share of high-margin value added products (VAP) is likely to boost its margins in coming years.

Favorable market dynamics: Indian dairy industry is valued at ~₹600000 cr, growing at 10%+CAGR which presents a strong opportunity for the organized sector (currently contributes ~22%). Driven by rising awareness and income level, organized players share's is expected to increase to 26% by 2020. PARAG is likely to be one of the key beneficiaries of this shift.

Product portfolio shifting towards high margin products: VAP like cheese, whey protein enjoy higher gross margins of 25-45% versus 6-8% entailed in liquid milk. VAP forms ~66% to its revenue (the highest among the listed players versus 25-30% for others). With rising health awareness, its whey protein brand (Avvataar) could be a >₹150 crore brand in next 2-3 years. Driven by recently launched products and higher share of VAP, its operating margins would improve to 10-11% in next few years.

Reducing leverage and improving return ratios: PARAG is likely to incur a capex of ~₹150 cr over FY2017-20 which is to be internally funded. With regular debt repayments, DE ratio is also likely to go down. With improving margins, its return ratios would normalize to 14-15% after making a temporary dip in FY2017.

Outlook and valuation: We expect PARAG to report net revenue/PAT CAGR of 13%/27% respectively over FY2018-20E. The stock currently trades at a P/E of 14.9x FY2020E EPS. It is increasingly becoming a stable brand story while it is still valued as commodity business. We feel that the company should somewhere start enjoying the valuation of FMCG companies. We initiate coverage on the stock with a BUY recommendation and Target Price of ₹333 (20x FY2020E EPS), an upside of 34% from the current levels.

Key Financials (Consolidated)

Y/E March (Rs cr)	FY2016	FY2017E	FY2018E	FY2019E	FY2020E
Net Sales	1,645	1,731	1,957	2,214	2,498
% chg	13.9	5.2	13.1	13.1	12.9
Net Profit	49.4	35.9	86.7	116.3	140.2
% chg	33.0	(27.2)	141.4	34.1	20.5
OPM (%)	9.0	5.1	9.7	10.4	10.6
EPS (Rs)	5.9	4.3	10.3	13.8	16.7
P/E (x)	42.4	58.3	24.1	18.0	14.9
P/BV (x)	5.8	3.2	2.8	2.4	2.1
RoE (%)	13.6	5.5	11.7	13.5	14.0
RoCE (%)	15.3	4.3	14.3	16.6	18.0
EV/Sales (x)	1.5	1.3	1.1	1.0	0.9
EV/EBITDA (x)	16.7	25.4	11.7	9.6	8.2

Source: Company, Angel Research; Note: closing price of April 13, 2018

BUY

CMP	₹249
Target Price	₹333

Investment Period	12 Months
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Stock Info

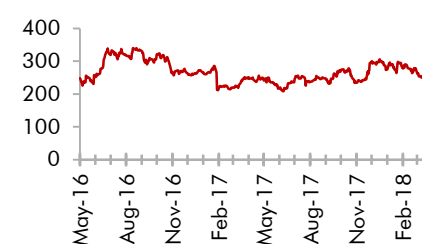
Sector	Dairy Products
Market Cap (₹ cr)	2,092
Net Debt (₹ cr)	162
Beta	1.1
52 Week High / Low	319/206
Avg. Daily Volume	2,12,755
Face Value (₹)	10
BSE Sensex	34,192
Nifty	10,480
Reuters Code	PAMF.NS
Bloomberg Code	PARAG.IN

Shareholding Pattern (%)

Promoters	48.7
MF / Banks / Indian Fls	13.0
FII / NRIs / OCBs	17.5
Indian Public / Others	20.9

Abs. (%)	3m	1yr	3yr
Sensex	(1.4)	15.0	16.7
PARAG	(13.4)	1.5	-

Price Chart



Source: Company, Angel Research

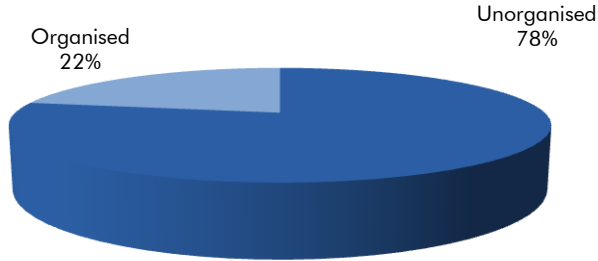
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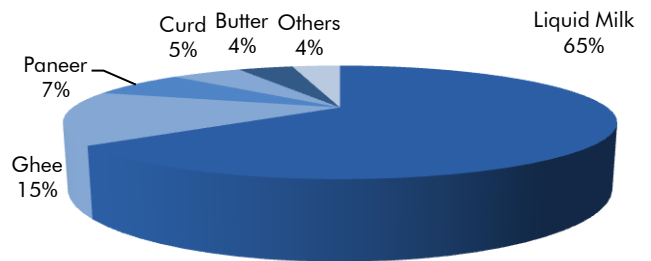
Parag Milk Foods in charts

Exhibit 1: Organised dairy industry forms only 22%



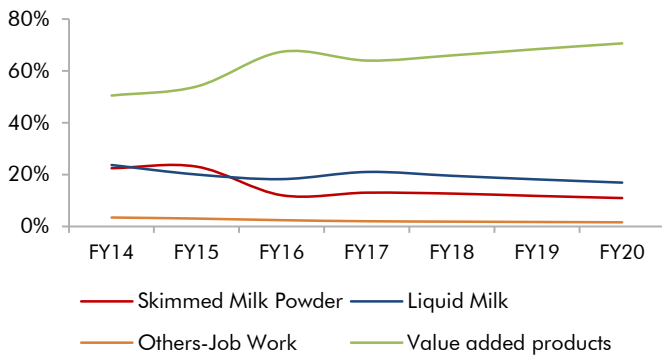
Source: Company, Angel Research

Exhibit 2: Liquid Milk forms the biggest chunk



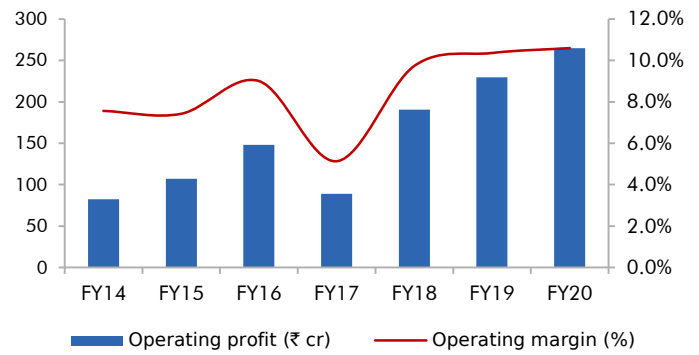
Source: Company, Angel Research

Exhibit 3: Share of VAP to go up for Parag....



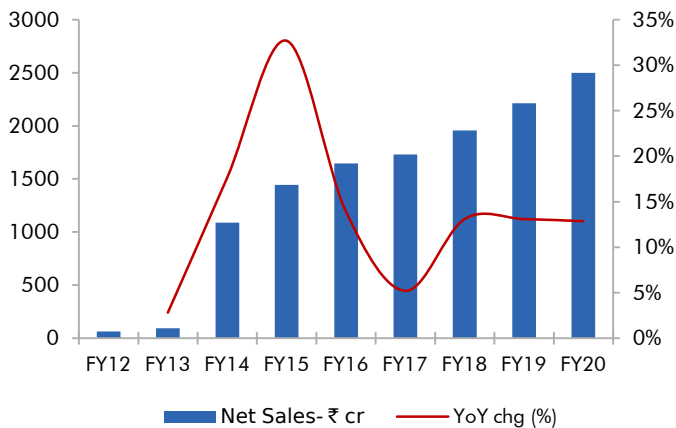
Source: Company, Angel Research

Exhibit 4: Improving its margin profile



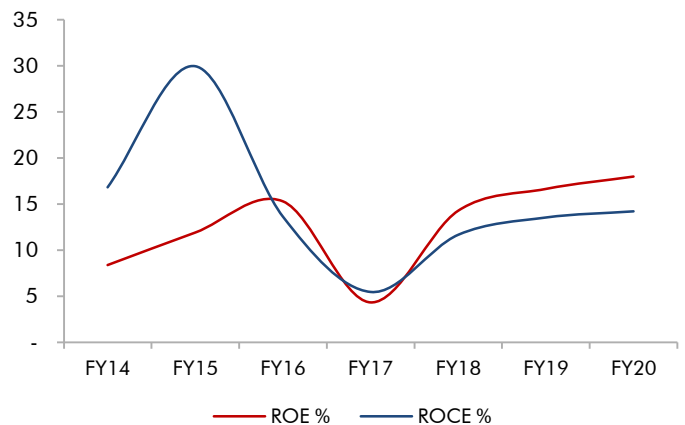
Source: Company, Angel Research

Exhibit 5: Revenue to grow well for next few years



Source: Company, Angel Research

Exhibit 6: Return ratios normalising after FY2017 dip



Source: Company, Angel Research

Company background

PARAG 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. In 1998, the company set up Bhagyalaxmi Dairy Farm - India's most modern dairy farm with the finest international equipments. It manufactures a diverse range of products including cheese, ghee (clarified butter), fresh milk, whey proteins, paneer, curd, yoghurt, milk powders and dairy based beverages. 'Gowardhan' and 'Go', its flagship brands, are among the leading ghee, cheese and other value added product brands in India. It also supply farm-to-home premium fresh milk from Bhagyalaxmi Dairy Farm, which it market and sell under 'Pride of Cows' brand in Mumbai and Pune.

Exhibit 7: Well diversified branded portfolio

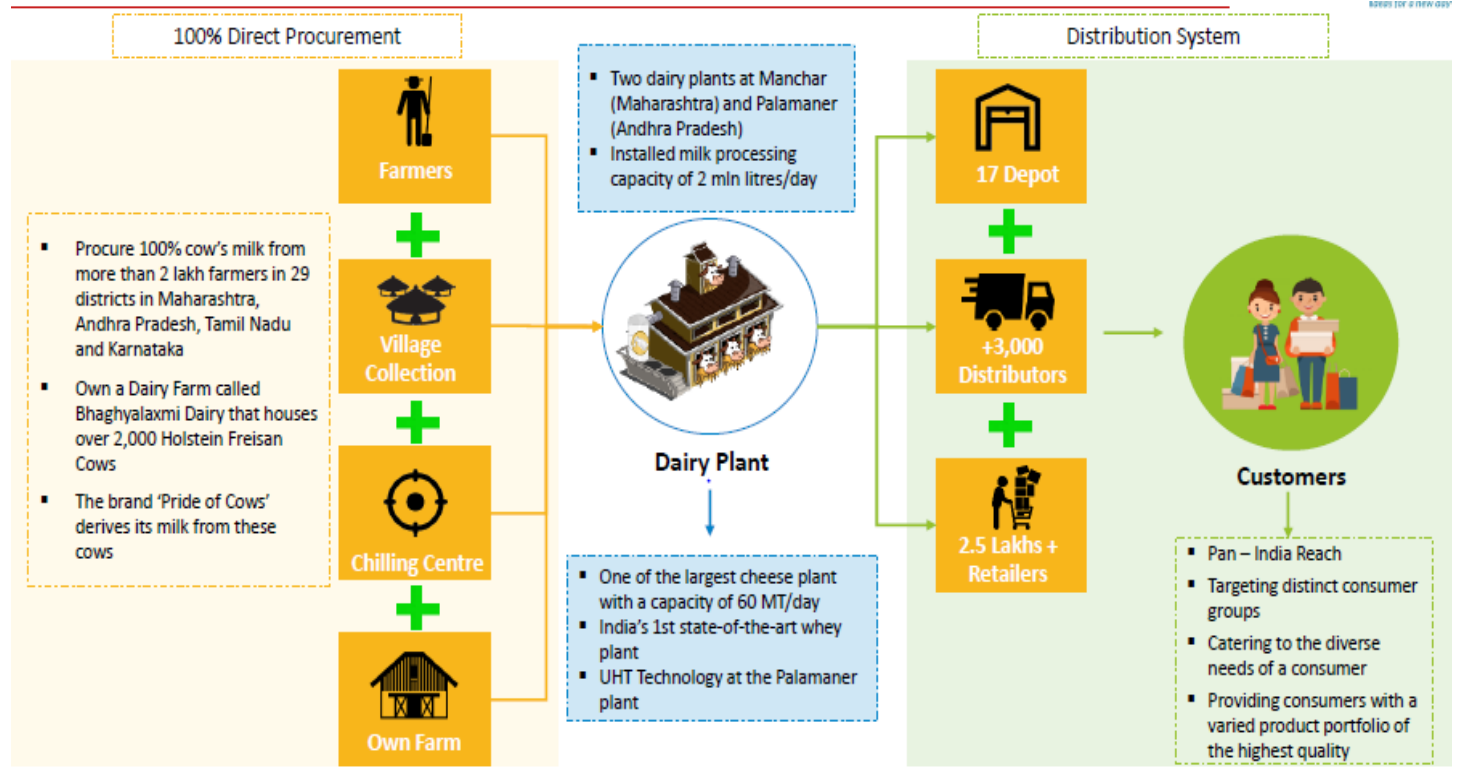


Source: Company

Milk procurement and processing capabilities

Its 3-tier milk procurement system involves over 2,00,000 farmers from 29 districts of Maharashtra, Andhra Pradesh, Karnataka and Tamil Nadu through more than 3,400 village-level milk collection centres collecting nearly 1.2 million litres of milk every day. It has two manufacturing plants at Manchar in Maharashtra and Palamaner in Andhra Pradesh. Its current processing capacity is 2 million litres per day between two plants. It cheese capacity has been increased from 40 MT to 60 MT per day. It also has the first-of-its-kind whey processing plant and a fully automated Paneer plant with capacity of 20 MT per day.

Exhibit 8: Procurement and distribution system of PARAG



Source: Company, Angel Research

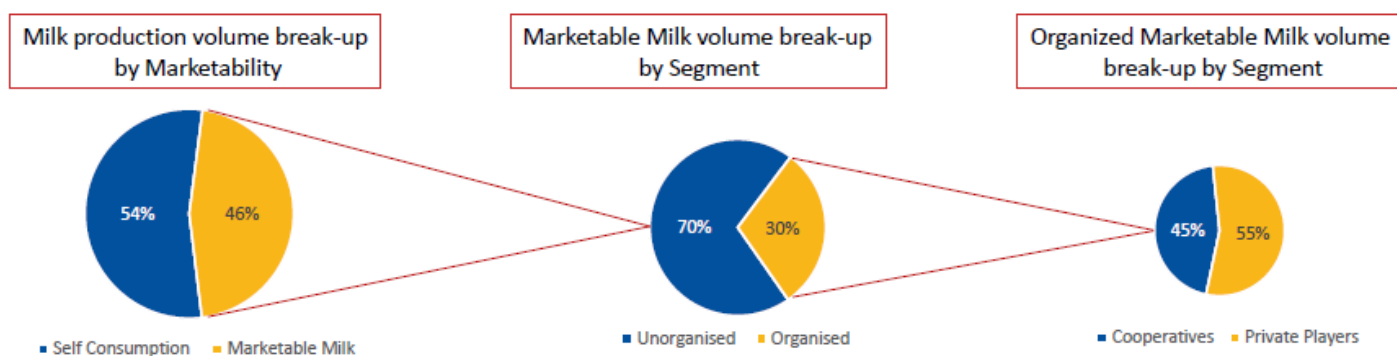
Investment Rationale

Favorable market dynamics:

1. Shift from unorganized to organized

Indian dairy industry is valued at ₹600000 cr+, growing at ~10%+ CAGR. This growth presents a strong opportunity for the organized sector which currently contributes ~22%. In India, over 80% of milk is consumed in the liquid form, as opposed to developed countries that consume a large portion of milk in the form of dairy products/VAP. Driven by rising awareness, new products launch, aggressive marketing (by leading players) and income level, organized players share's is expected to increase to 26% by 2020. PARAG is likely to be one of the key beneficiaries of this shift.

Exhibit 9: Currently >10% of the milk production is marketed by private players



Source: Company, Angel Research

2. Increasing health awareness and innovation

Consumers are increasingly health conscious and are preferring nutritious, low-carb, high-protein meals. They are experimenting with niche categories and therefore demand is fast growing for products like milk-based juice drinks, sports nutrition like whey protein, amongst others. ~31% of Indian population is vegetarian, for whom milk is a important source of vital nutrients.

Over the past decade, VAPs have been rapidly growing due to:

- 1) Rising income levels due to a rising middle class and working population
- 2) Rising number of dual income households through increase in the number of working women
- 3) Increase in urban population
- 4) Rapidly expanding food service industry (Rise in HORECA - Hotels, Restaurants & Caterers segment)
- 5) Aggressive spending on advertisement and sales promotions by organised players to create awareness among consumers

3. Changing Dietary Patterns

Over the years, the consumption trend has changed with people shifting from home-made dahi, ghee and paneer to branded products due to convenience in

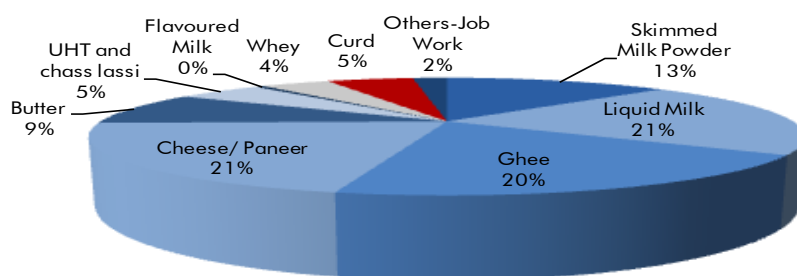
buying and higher assurance of quality. This has promoted the growth in demand for dairy and VAP.

Product portfolio shifting towards high margin products

Well established brands and diversified product portfolio

PARAG has well recognized brands like 'Gowardhan' and 'Go' in its portfolio. It markets dairy products (milk, ghee, paneer, butter, etc) and processed cheese blocks under the 'Gowardhan' brand. It has launched a wide range of cheese products, UHT, fresh cream etc, since 2008 under the 'Go' brand which have gained good traction since their launches. 'Gowardhan' has been recognized as the most trusted brand in the food products category and 'Go' has been acknowledged as the "Most Promising Brand" in the FMCG category. 'Go' cheese has been competing with products of the established market leader- Amul and has grabbed 33% of market share in a short span of 10 years. It has other brands like 'Pride of Cows' (premium quality cow milk) and 'Topp Up' (beverages).

Exhibit 10: FY2017 revenue break-up



Source: Company

Exhibit 11: Differentiated brand and product portfolio

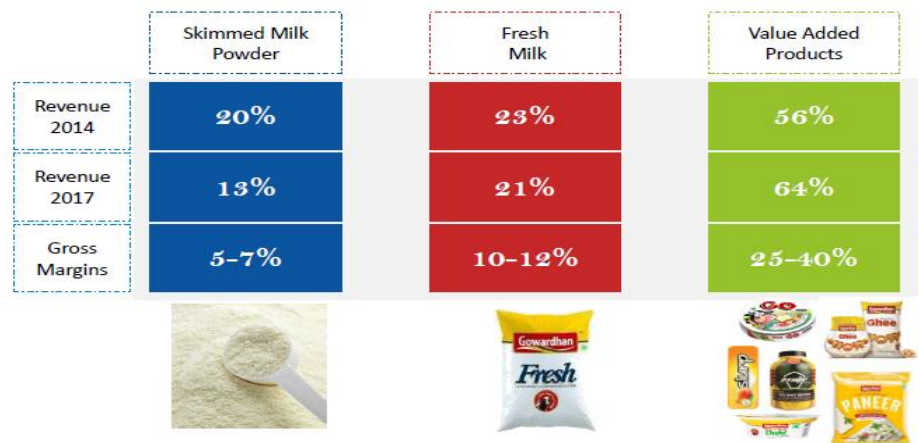
Brand	Product	Target customer group
	<ul style="list-style-type: none"> Fresh milk Curd Ghee Paneer Butter Milk powder Whey protein 	<ul style="list-style-type: none"> House-hold consumption for traditional Indian recipes; used as ingredients
	<ul style="list-style-type: none"> Cheese UHT Fruit yoghurt Fresh cream Lassi Buttermilk Badam milk 	<ul style="list-style-type: none"> Children and youth for direct consumption
	<ul style="list-style-type: none"> Premium cow milk 	<ul style="list-style-type: none"> Household consumers seeking premium quality cow milk
	<ul style="list-style-type: none"> Flavoured milk 	<ul style="list-style-type: none"> Youth and travellers as source of instant nourishment

Source: Company

Product portfolio shifting towards high margin products

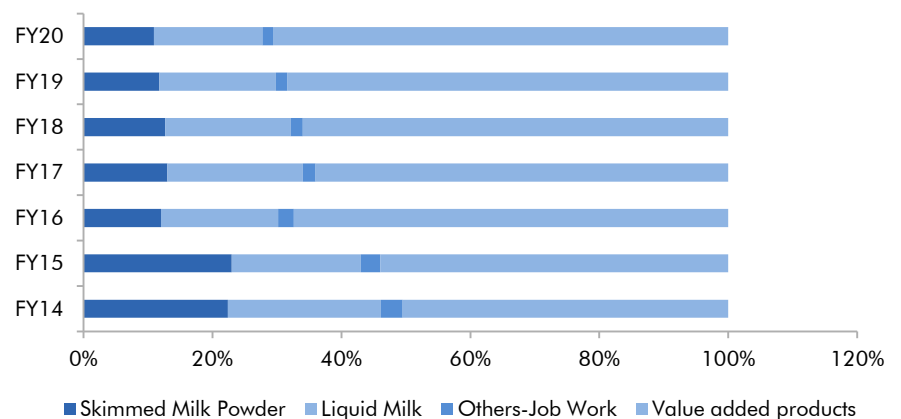
Value Added Products (VAP) like paneer, whey protein and cheese enjoy higher gross margins of 25-45% as compared to 6-8% margins entailed in liquid milk. VAP currently contributes ~66% to its revenue (highest in the industry as against 25-30% for other leading players). This is likely to touch 75% in next 2-3 years. Increasing VAP's revenue share will almost double its margins from 5.4% in FY2017 to 10.6% in FY2020. In M9FY2018, the company has registered a OPM of 9.6%, increased from 2.4% in M9FY2017.

Exhibit 12: Product-wise revenue contribution and margins



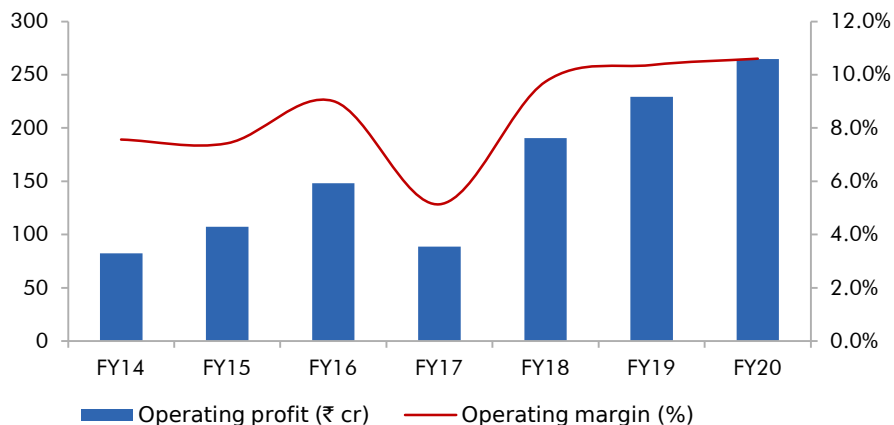
Source: Company

Exhibit 13: Rising revenue share of VAP would boost margins



Source: Company, Angel Research

Exhibit 14: Improving margin profile



Source: Company, Angel Research

New category holding good potential

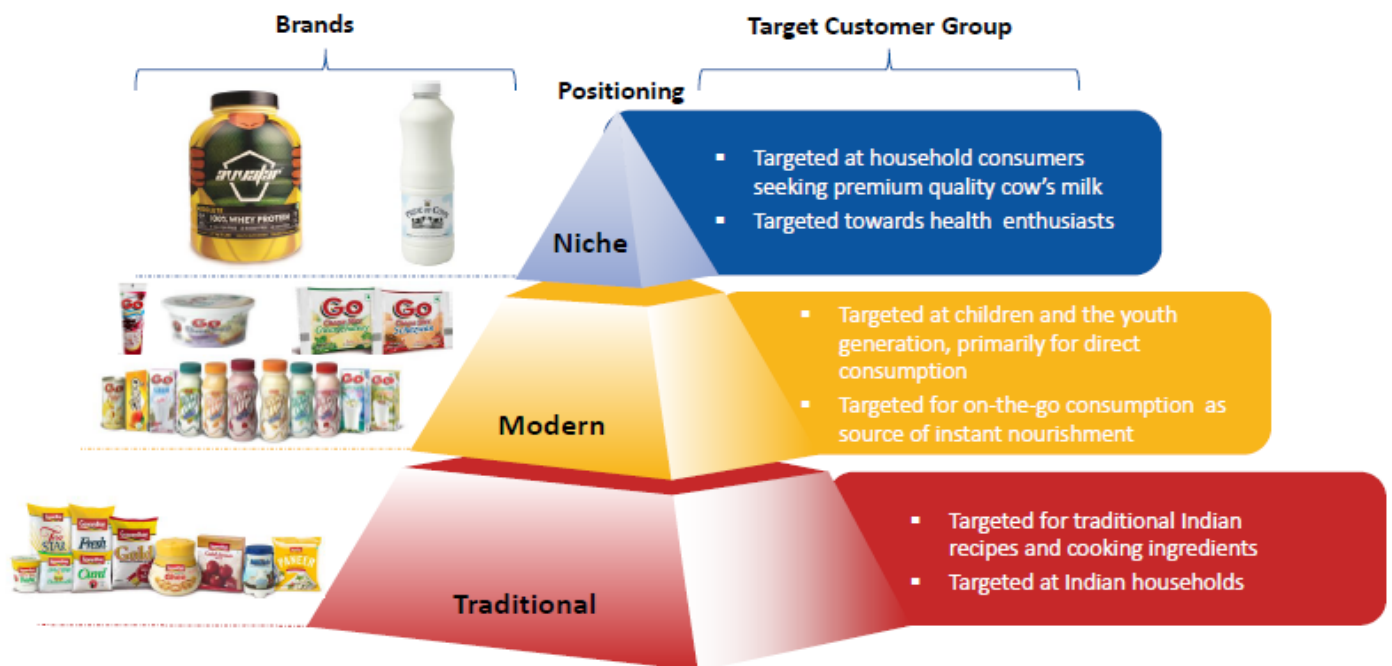
Whey protein under Avvatar brand

Avvatar is the first Indian whey protein powder which is pure vegetarian and is derived from milk protein only and is soya free and sugar free. 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 recently, 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. The product is being distributed via tie ups with premium sports gyms, nutrition outlets and e-portals like Amazon.

Whey protein market dominated by imports- PARAG can substitute

Currently, the market is dominated by imported brands that constitute around 80-90% of the overall pie. The market size is estimated at ₹1500 cr, growing at 12-13% CAGR. The market is dominated by imported brands that dominates over 80% of the market as there is no domestic brand in the market. Hence, with introduction of Avvatar, Parag has become first mover in this category and can capture this high margin segment (40%) as the imported products become little dated while Avvatar being a local brand offers a fresher and effective substitute. Avvatar's revenue are expected to touch ₹20cr in FY2018. With a better distribution and marketing strategy, the product sale is expected to touch ₹100 cr in FY2019 and could be ₹150cr brand in another 1-2 years.

Exhibit 15: Focus towards modern products which current forms only 10% of the organized market



Source: Company

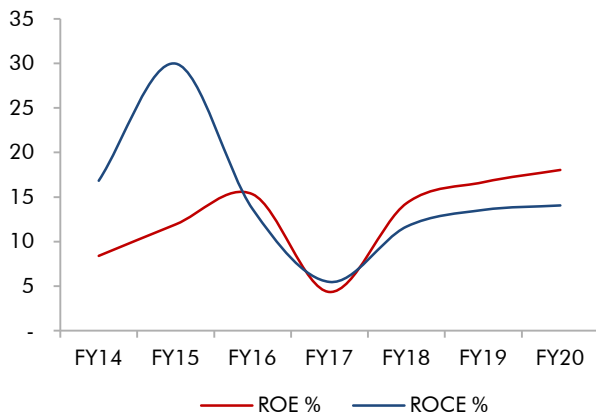
Emerged as the leading player in cheese in a short span

Cheese accounts for 21% of its FY2017 revenue and has grown to command 33% market share in Indian cheese market mainly driven by constant new product launch and aggressive marketing. Indian processed cheese market is valued at ~₹ 1000 cr market in FY2017 and is growing in excess of 15% for past couple of years. Amul is the market leader with 40% market share, Britannia-9% and Dynamix - 7%. The Indian fast food market is growing rapidly and cheese is quite popularly consumed with a number of fast foods such as Pizzas, Burgers, Garlic breads, and Sandwiches. Apart from western dishes, cheese is also being added as a taste enhancer in several traditional Indian recipes such as Dosas, Paratha, Pav Bhaji, amongst others. These trends would keep the buoyant demand for PARAG cheese segment.

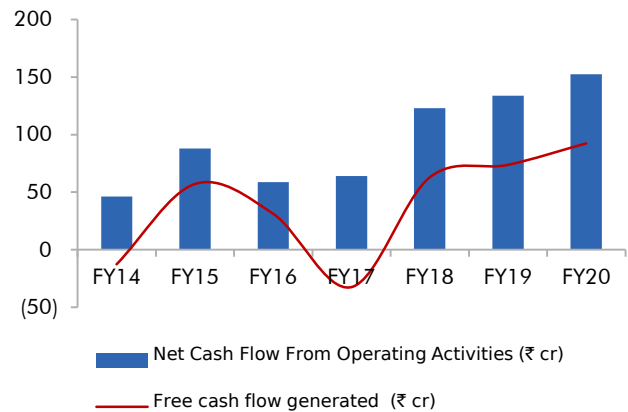
Reducing leverage and improving return ratios

Demonetization and high raw milk procurement prices had led to poor performance in FY2017. With improving margins, its return ratios would also return to 14-15% from the temporary dip made in FY2017. Debt is expected to reduce over the next three years from the stabilization of profitability since FY2018.

The company is likely to invest over ₹150 cr over FY2017-20 in its manufacturing facilities which is to be funded by mix of IPO proceeds and internal accruals. The company is likely to generate ~₹100 cr+ annually as operating cash inflow which would fund its annual capex plan of ~ ₹50-60 cr.

Exhibit 16: Improving return ratios


Source: Company, Angel Research

Exhibit 17: Capex to be largely funded internally


Source: Company, Angel Research

Outlook

We expect PARAG to report net revenue/PAT CAGR of 13%/27% respectively over FY2018-20E driven by new product launch in VAP and reduction in interest cost. When compared with its peers, its revenue growth is largely in line. However, due to increasing share of VAP (which is already highest among the listed players), its margin expansion will also be highest in the industry in FY2020.

Exhibit 18: Peer financial comparison

Company name	Revenue (₹ cr)				CAGR %	EBITDA (₹ cr)			EBITDA Margin %		
	FY17	FY18	FY19	FY20		FY18	FY19	FY20	FY18	FY19	FY20
Hatsun Agro	4190	4790	5850	6837	17.7%	445	445	445	9.3%	7.6%	6.5%
Heritage Foods	2573	2593	3022	3521	11.0%	142	197	252	5.5%	6.5%	7.2%
Prabhat	1410	1599	1822	2082	13.9%	139	139	139	8.7%	7.6%	6.7%
Parag	1731	1957	2214	2498	13.0%	191	229	265	9.7%	10.4%	10.6%

Source: Bloomberg, Angel Research

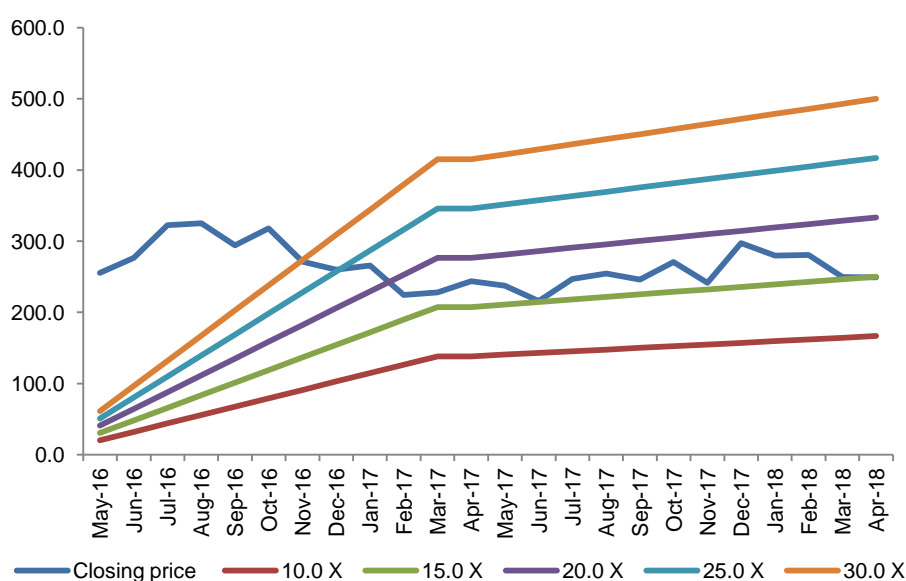
Valuation

The stock currently trades at a P/E of 14.9x its FY2020E EPS which looks very attractive, looking its stable growth trajectory. The company is increasingly becoming a stable brand play while it is still valued as a commodity business. We feel that the company should somewhere start enjoying the valuation of FMCG companies. When compared with peers also, the company is trading at substantial discount to most of its peers. Hence, we initiate coverage on the stock with a BUY recommendation and Target Price of ₹333 (20x FY2020E EPS), an upside of 34% from the current levels.

Exhibit 19: Peer valuation comparison

	(₹)	EPS (₹)				EPS CAGR %	P/E (x)			ROE (%)			
	CMP	FY17	FY18	FY19	FY20		FY18	FY19	FY20	FY17	FY18	FY19	FY20
Hatsun Agro	737	8.8	9.9	15.0	20.5	32.4	74.8	49.3	36.0	46.4	34.1	38.9	38.8
Heritage Foods	750	14.4	14.2	20.9	28.9	26.1	52.7	35.9	25.9	24.7	20.8	24.4	25.3
Prabhat Dairy	177	3.5	4.9	6.9	9.4	39.3	36.4	25.6	18.8	7.0	6.5	8.7	10.8
Parag Milk Foods	249	4.3	10.3	13.8	16.7	57.4	24.1	18.0	14.9	5.5	11.7	13.5	14.0

Source: Company, Angel Research

Exhibit 20: Forward PE chart


Source: Company, Angel Research

Risks and concerns

- Inability to procure sufficient good quality raw milk at commercially viable prices may adversely impact the operation as milk is a key raw material for all dairy products.
- The dairy industry is highly competitive with multiple players sourcing milk from the same region and price war. Such competition can have an impact on raw milk prices.
- The company is subject to various regulations relating to product liability, particularly relating to food safety of its products. Product contamination or similar occurrences can result in regulatory actions against the company and impact the business performance.

Income statement

Y/E March (₹ cr)	FY2016	FY2017	FY2018E	FY2019E	FY2020E
Total operating income	1,645	1,731	1,957	2,214	2,498
% chg	13.9	5.2	13.1	13.1	12.9
Total Expenditure	1,497	1,642	1,767	1,984	2,233
Raw Material	1,333	1,414	1,520	1,710	1,924
Personnel	67	79	86	93	105
Selling and Administration Expenses	82.4	113.1	121.4	137.2	154.9
Others Expenses	15	36	39	44	50
EBITDA	148	89	191	229	265
% chg	38.2	(40.1)	114.7	20.3	15.4
(% of Net Sales)	9.0	5.1	9.7	10.4	10.6
Depreciation & Amortisation	33	49	54	59	65
EBIT	115	40	136	170	200
% chg	44.1	(65.3)	242.9	24.5	17.7
(% of Net Sales)	7.0	2.3	7.0	7.7	8.0
Interest & other Charges	50	33	24	18	13
Other Income	2	11	5	5	5
(% of PBT)	2.3	62.7	4.3	3.2	2.6
Share in profit of Associates	-	-	-	-	-
Recurring PBT	67	18	117	157	192
% chg	94.9	(73.8)	569.1	34.1	22.2
Tax	19	0	30	41	52
(% of PBT)	29.2	2.3	26.0	26.0	27.0
PAT (reported)	47	17	87	116	140
Extraordinary Items	(2)	(19)	-	-	-
Less: Minority interest (MI)	0	0	0	0	0
PAT after MI (reported)	47	17	87	116	140
ADJ. PAT	49	36	87	116	140
% chg	33.0	(27.2)	141.4	34.1	20.5
(% of Net Sales)	3.0	2.1	4.4	5.3	5.6
Fully Diluted EPS (₹)	5.9	4.3	10.3	13.8	16.7
% chg	33.0	(27.2)	141.4	34.1	20.5

Source: Company, Angel Research

Balance sheet

Y/E March (₹ cr)	FY2016	FY2017	FY2018E	FY2019E	FY2020E
SOURCES OF FUNDS					
Equity Share Capital	70	84	84	84	84
Reserves & Surplus	291	573	659	775	914
Shareholders Funds	362	657	743	859	998
Equity Share Warrants	-	-	-	-	-
Total Loans	389	262	212	162	112
Deferred Tax Liability	-	-	-	-	-
Other liabilities	18.7	18.1	18.1	18.1	18.1
Total Liabilities	769	938	974	1,039	1,129
APPLICATION OF FUNDS					
Gross Block	528	585	645	705	765
Less: Acc. Depreciation	183	226	280	340	404
Net Block	345	359	365	365	361
Capital Work-in-Progress	28	21	21	21	21
Investments	-	-	-	-	-
Current Assets	602	878	916	1,004	1,120
Inventories	272	429	456	515	582
Sundry Debtors	236	215	241	273	308
Cash	8	101	68	45	38
Loans & Advances	85	133	151	171	193
Other Assets	-	-	-	-	-
Current liabilities	211	382	411	462	520
Net Current Assets	391	496	505	542	600
Deferred Tax Asset	(11)	(10)	(11)	(12)	(12)
Total Assets	769	938	974	1,039	1,129

Source: Company, Angel Research

Cash flow statement

Y/E March (₹ cr)	FY2016	FY2017	FY2018E	FY2019E	FY2020E
Profit before tax	67	18	117	157	192
Depreciation	33	49	54	59	65
Change in Working Capital	0	0	(42)	(60)	(65)
Interest / Dividend (Net)	47	25	24	18	13
Direct taxes paid	(14)	(16)	(30)	(41)	(52)
Others	(75)	(11)	0	0	0
Cash Flow from Operations	59	64	123	134	152
(Inc.)/ Dec. in Fixed Assets	(27)	(97)	(60)	(60)	(60)
(Inc.)/ Dec. in Investments	(4)	6	(22)	(28)	(37)
Cash Flow from Investing	(31)	(91)	(82)	(88)	(97)
Issue of Equity	6	278	0	0	0
Inc./(Dec.) in loans	60	0	(50)	(50)	(50)
Dividend Paid (Incl. Tax)	0	0	0	0	0
Interest / Dividend (Net)	(55)	(31)	(24)	(18)	(13)
Cash Flow from Financing	(26)	123	(74)	(68)	(63)
Inc./(Dec.) in Cash	1	96	(33)	(22)	(7)
Opening Cash balances	4	5	101	68	45
Closing Cash balances	5	101	68	45	38

Source: Company, Angel Research

Key Ratios

Y/E March	FY2016	FY2017	FY2018E	FY2019E	FY2020E
Valuation Ratio (x)					
P/E (on FDEPS)	42.4	58.3	24.1	18.0	14.9
P/CEPS	26.0	31.7	14.9	11.9	10.2
P/BV	5.8	3.2	2.8	2.4	2.1
Dividend yield (%)	0.1	0.2	0.0	0.0	0.0
EV/Sales	1.5	1.3	1.1	1.0	0.9
EV/EBITDA	16.7	25.4	11.7	9.6	8.2
EV / Total Assets	3.2	2.4	2.3	2.1	1.9
Per Share Data (₹)					
EPS (fully diluted)	5.9	4.3	10.3	13.8	16.7
Cash EPS	9.6	7.9	16.7	20.9	24.4
DPS	0.2	0.4	0.1	0.1	0.1
Book Value	43.0	78.2	88.4	102.1	118.7
Dupont Analysis					
EBIT margin	7.0	2.3	7.0	7.7	8.0
Tax retention ratio	0.7	1.0	0.7	0.7	0.7
Asset turnover (x)	2.2	2.1	2.2	2.3	2.3
ROIC (Post-tax)	10.9	4.8	11.4	12.9	13.6
Cost of Debt (Post Tax)	0.1	0.1	0.1	0.1	0.1
Returns (%)					
ROCE	15.3	4.3	14.3	16.6	18.0
Angel ROIC (Pre-tax)	15.5	4.9	15.4	17.4	18.7
ROE	13.6	5.5	11.7	13.5	14.0
Turnover ratios (x)					
Asset Turnover (Gross Block)	3.1	3.0	3.0	3.1	3.3
Inventory / Sales (days)	60	90	85	85	85
Receivables (days)	52	45	45	45	45
Payables (days)	58	99	99	99	99
Working capital cycle (ex-cash) (days)	55	37	31	31	31
Solvency ratios (x)					
Net debt to equity	1.1	0.2	0.2	0.1	0.1
Net debt to EBITDA	2.6	1.8	0.8	0.5	0.3
Interest Coverage (EBIT / Interest)	2.3	1.2	5.6	9.5	15.3

Source: Company, Angel Research; Note: closing price of April 13, 2018

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Disclosure of Interest Statement

Parag Milk Foods Ltd.

1. Financial interest of research analyst or Angel or his Associate or his relative	No
2. Ownership of 1% or more of the stock by research analyst or Angel or associates or relatives	No
3. Served as an officer, director or employee of the company covered under Research	No
4. Broking relationship with company covered under Research	No

Ratings (Based on expected returns over 12 months investment period):

Buy (> 15%)

Accumulate (5% to 15%)
Reduce (-5% to -15%)

Neutral (-5 to 5%)
Sell (< -15)