

I India
HOLD (previously ADD)

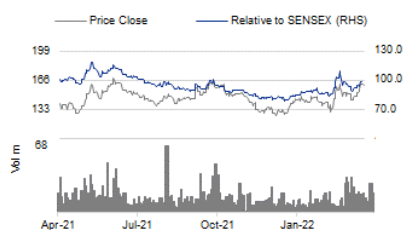
Consensus ratings*: Buy 32 Hold 1 Sell 0

Current price:	Rs161
Target price:	Rs182 ▲
Previous target:	Rs180
Up/downside:	13.0%
InCred Research / Consensus:	-6.6%
Reuters:	GAIL.NS
Bloomberg:	GAIL IN
Market cap:	US\$9,476m
	Rs713,792m
Average daily turnover:	US\$25.5m
	Rs1919.5m
Current shares o/s:	4,440.4m
Free float:	35.0%

*Source: Bloomberg

Key changes in this note

- EPS decline at a 6% CAGR is likely over FY22F-25F.
- Downgrade the stock from Add to Hold with a target price of Rs182.



Source: Bloomberg

Price performance	1M	3M	12M
Absolute (%)	3.4	18.2	19.1
Relative (%)	(6.6)	17.0	(2.6)

Major shareholders	% held
Govt of India	51.5
LIC	6.2
ONGC	4.9

Analyst(s)

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GAIL India

Consolidated EPS to fall; downgrade to Hold

- Huge contribution of trading gains in GAIL India's FY22F profit, in our view, to come down in coming years and petchem margin to also fall.
- While gas transmission revenue and profit will go up as India starts four new fertilizer plants, we believe there will be flat-to-declining CNG volume.
- Consolidated EPS decline at a 6% CAGR is likely over FY22F-25F. We downgrade the stock to Hold (from Add earlier).

FY22F profit to be mainly driven by trading gains which won't repeat

3QFY22 trading EBITDA on natural gas at Rs19bn was equal to FY20 total trading EBITDA. We appreciate management's guidance that such a performance is unlikely to get repeated. However, an analysis of LNG prices and trading gains of GAIL indicates that the company makes money in a stable or a rising LNG scenario but if there is volatility, like in FY21, it tends to lose money. While we have built in Rs20bn trading EBITDA in FY23F, this number is at high risk. Also, petchem margins are declining. IHS Markit indicates that naphtha-based ethylene makers are losing money in Southeast Asia. While GAIL won't lose money, it's unlikely that there will be significant YoY growth in segment EBITDA in FY23F. On the LPG and liquid hydrocarbon front also, the company will do bets if it can't maintain FY22F EBITDA in FY23F as the government may force a lower rise in LPG prices. On an overall basis, there are too many unknowns, and the stock is rightfully trading at a significant discount to its historical mean valuation.

Government action on APM gas can be another headwind

All the money made in petchem business is because of cheap gas. Given the big subsidy pressure of urea, it won't be surprising if the government reduces APM gas allocation to the petchem sector. While it's not in our base case, it's a likely scenario. Please note that on current urea and LNG prices, government subsidy on urea will exceed Rs2tr, approximately 3x the budgeted amount. In a most likely scenario (also political compulsions given assembly elections) urea prices cannot be increased and hence, APM gas will have to be supplied to urea plants which is still 80% cheaper compared to international prices.

Valuation doesn't justify selling; downgrade to Hold

GAIL trades at one of the lowest valuations of last 10 years and hence, to some extent is building in the current headwinds. We downgrade the stock to Hold (from Add earlier) with a 12-month target price of Rs182 (from Rs180 earlier). Risks: Upside risk is from improvement in global petchem margin which can lead to some EPS upside. Downside risk is any reduction in APM gas supply by the government of India to the petchem sector.

Financial Summary

	Mar-20A	Mar-21A	Mar-22F	Mar-23F	Mar-24F
Revenue (Rsm)	725,084	573,719	1,058,417	1,250,838	1,329,895
Operating EBITDA (Rsm)	90,250	72,438	149,245	114,472	118,731
Net Profit (Rsm)	94,220	61,364	116,343	84,706	88,022
Core EPS (Rs)	20.9	13.6	26.2	19.1	19.8
Core EPS Growth	43.9%	(34.8%)	92.3%	(27.2%)	3.9%
FD Core P/E (x)	7.69	11.80	6.14	8.43	8.11
DPS (Rs)	6.4	5.0	10.0	8.0	7.5
Dividend Yield	4.78%	3.11%	6.22%	4.98%	4.67%
EV/EBITDA (x)	7.57	9.01	4.11	5.80	5.65
P/FCFE (x)	47.67	25.76	18.95	39.90	23.57
Net Gearing	11.5%	10.1%	5.3%	14.2%	15.4%
P/BV (x)	1.47	1.36	1.20	1.13	1.05
ROE	19.8%	12.0%	20.6%	13.8%	13.4%
% Change In Core EPS Estimates			30.23%	7.31%	12.22%
InCred Research/Consensus EPS (x)			1.15	0.93	0.95

SOURCES: INCRED RESEARCH, COMPANY REPORTS

Consolidated EPS to fall; downgrade to Hold

Business background

GAIL has multiple business lines such as 1) gas transmission business, 2) city gas distribution business, 3) petrochemical business, mainly polypropylene and polyethylene, 4) liquid petrochemical business, 5) E&P business, and 6) trading business.

Figure 1: Various business heads of GAIL's portfolio are given below



Gas transmission business

GAIL is the pioneer of gas transmission business in India. It has around 13,700km of natural gas pipeline and another 6,000km is in the construction phase.

As of now, different pipeline tariff is decided by PNGRB ➤

Petroleum and Natural Gas Regulatory Board (PNGRB) decides the tariff for gas transmission through pipelines. The basic premise is to guarantee a reasonable rate of return to the infrastructure builder. In the recent past, PNGRB came up with the proposal of unified tariff across different pipeline networks, but it also said that this provision will be revenue-neutral for existing licence holders or transmission pipeline owners.

GAIL operates the following pipeline networks for transmission of natural gas ➤

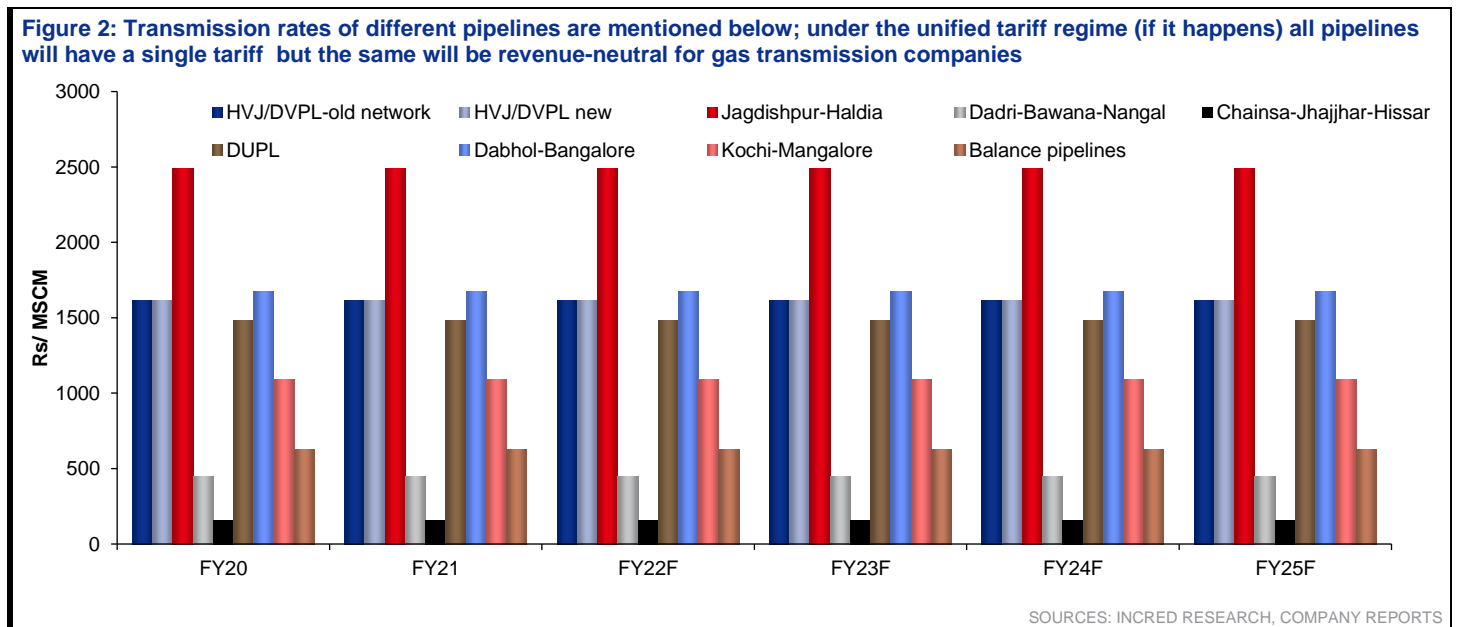
- HVJ-** Hazira-Vijaipur-Jagdishpur is India's first cross-state gas pipeline. The project was started in 1986, after the incorporation of GAIL India Limited to supply gas to the fertilizer plants located in Uttar Pradesh.
- DVPL-** The Dahej-Vijaipur (DVPL)-Vijaipur-Dadri (GREP) Upgradation DVPL 2 & VDPL project includes the 610km-long Dahej-Vijaipur Pipeline (DVPL-

II) and another 505km-long Vijaipur-Dadri Gas Pipeline (GREP-II) running parallel to the GREP-I pipeline.

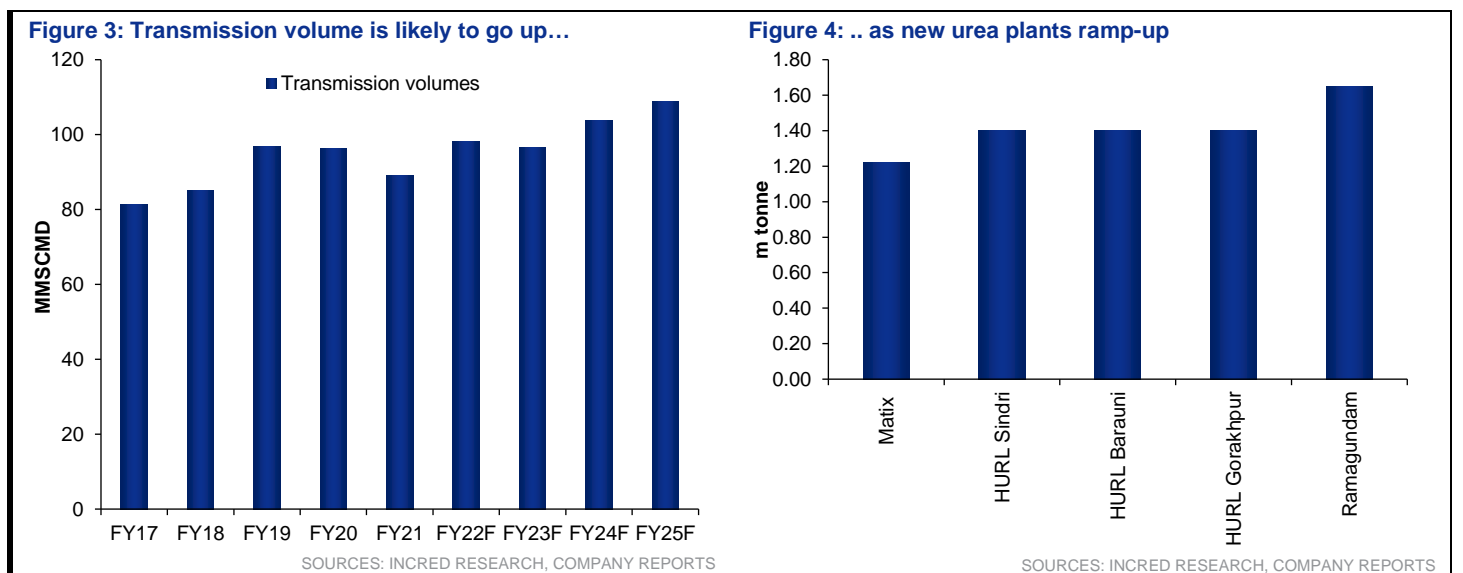
3. **Jagdishpur-Haldia**- This will be a part of the bigger gas project of Jagdishpur-Haldia-Bokaro-Dhamra Natural Gas Pipeline (JHBDPL), also known as Pradhan Mantri Urja Ganga Pipeline Project, which is an under - construction natural gas pipeline in India.
4. **DUPL**- Dahej-Hazira-Uran pipeline (DUPL).
5. Dabhol-Bengaluru pipeline.
6. Kochi-Mangaluru pipeline.
7. Balance pipelines.

All these pipelines have different tariff structures. There is a proposed structure where there will be unified tariff, but at the same time it's also guaranteed that the new regime will be revenue-neutral.

Different pipelines have different rates of transmission in terms of Rs/MSCM ➤



Overall transmission volume will increase over the next couple of years as new urea plants get commissioned ➤



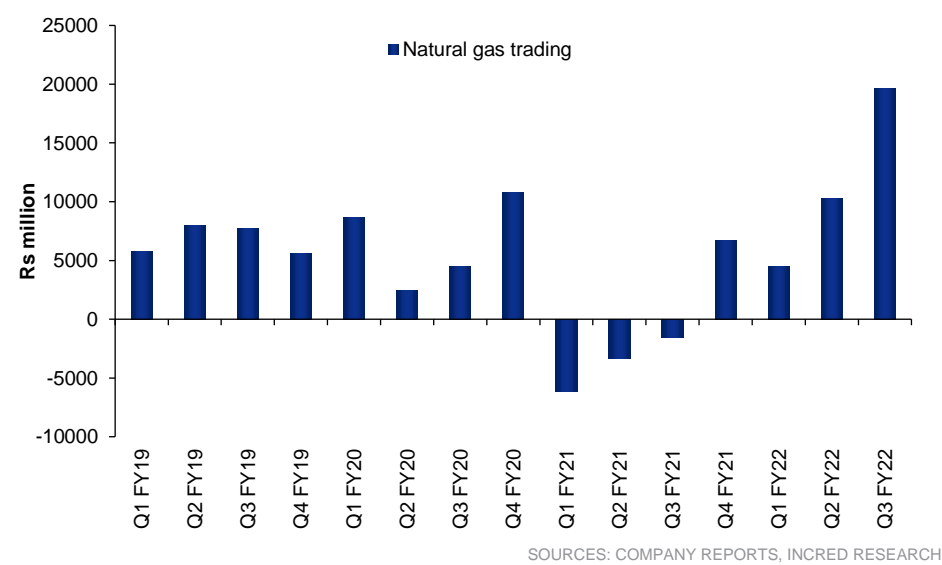
Gas trading business

Any trading business is fraught with risk. Firstly, an utility company like GAIL should not indulge in it. Even if it indulges in it, then there should be a proper risk management practice. However, we don't find any evidence for the same. Three continuous quarters of losses in FY21 and Rs20bn PBT in 3QFY22 indicates lack of proper risk management on the part of GAIL.

We are not particularly thrilled about the trading business ➤

In the volatile commodity price environment, trading business is fraught with risk. GAIL operates on wafer-thin margins and when underlying commodity prices increase, then this margin will be lost in the cost of hedging itself. 3QFY22 was just plain luck, and it won't get repeated.

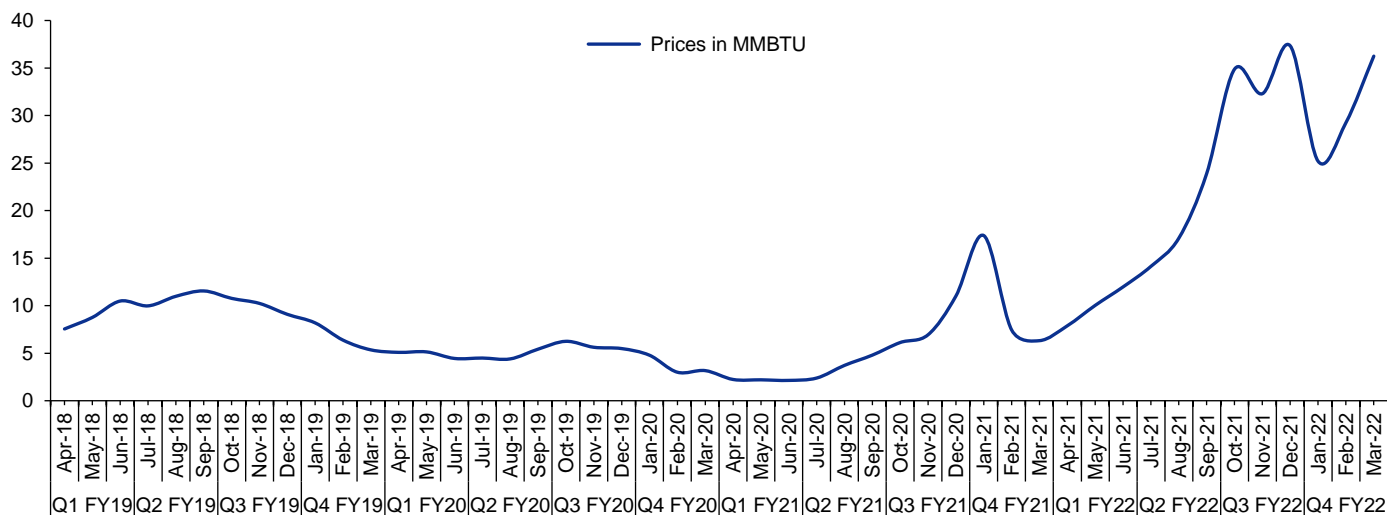
Figure 5: The nature of trading means that profit is highly volatile and sometimes losses are also inevitable



Normally, in a rising or steady commodity price scenario trading means money for GAIL ➤

4QFY22F will be a test for the risk management practice of GAIL. We could not find any reference of hedging in the company's FY21 annual report.

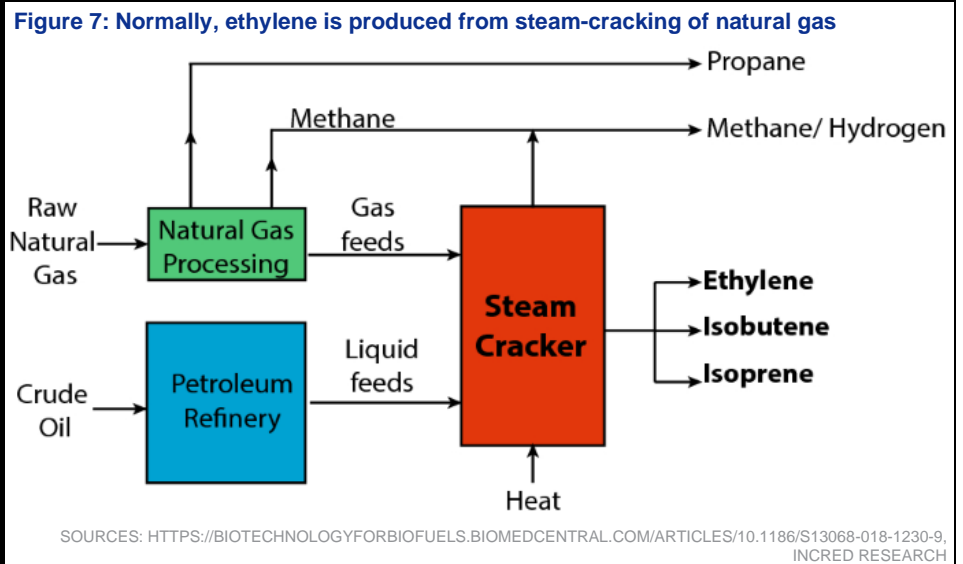
Figure 6: GAIL makes money when the underlying commodity i.e., LNG is rising or steady; in a volatile environment like 1Q, 2Q and 3QFY21 it tends to makes losses; LNG prices will remain highly volatile in coming months



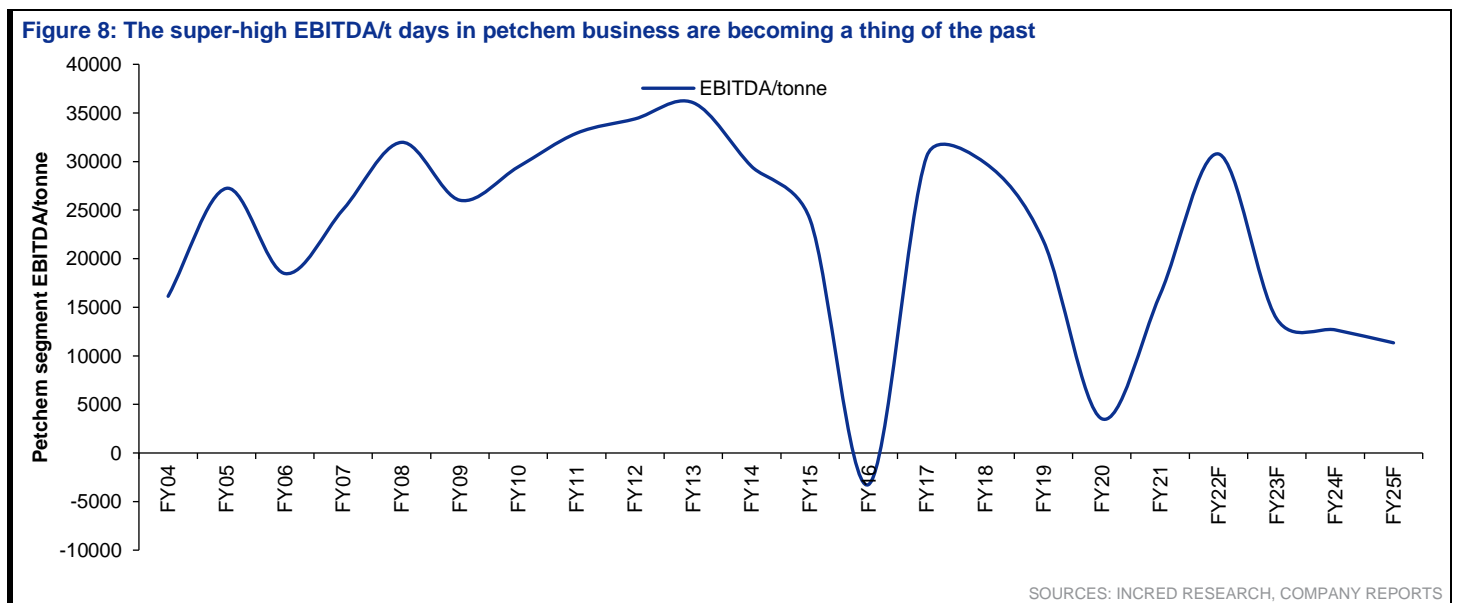
Petrochemical business

From natural gas GAIL makes ethylene, which is then converted into HDPE (high density polyethylene) and LDPE (low density polyethylene). Apart from PE (polyethylene), the company also makes propylene and butadiene.

Ethylene is produced from steam-cracking of natural gas ➤



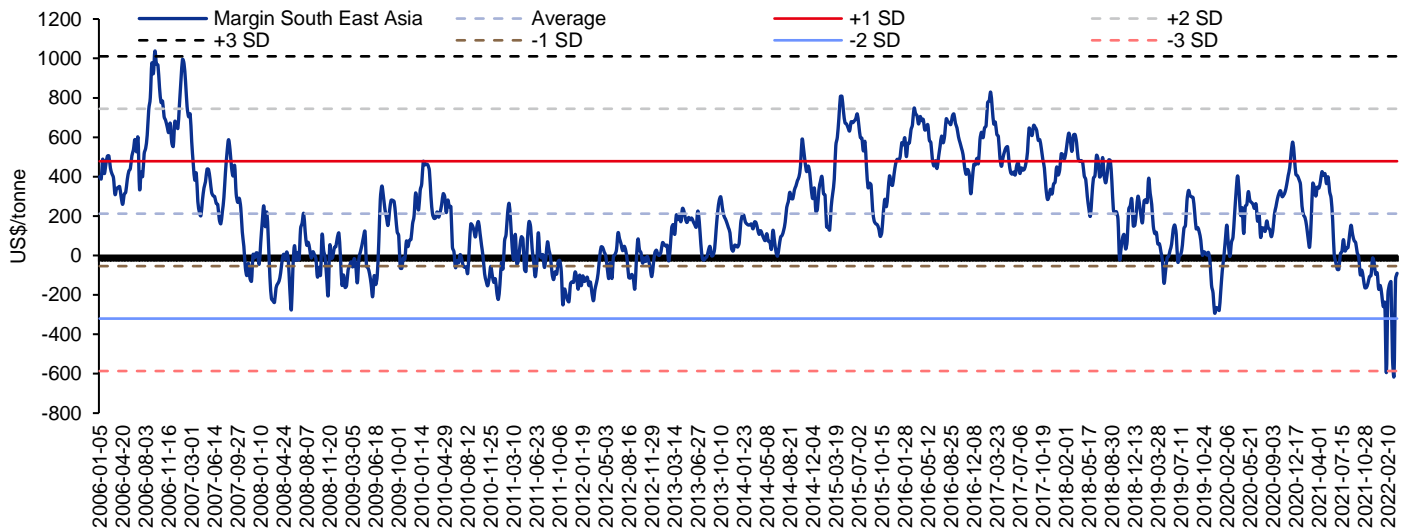
Because of low-priced APM gas, GAIL has made huge money in petchem business ➤



IHS Markit data indicates that ethylene production through the naphtha route is a losing proposition, clearly cost + pricing appears to be a thing of the past ➤

Most investors assume that ethylene maintains a certain positive spread over the raw material. However, current southeast Asian markets are indicating otherwise. Naphtha-based ethylene producers are losing money.

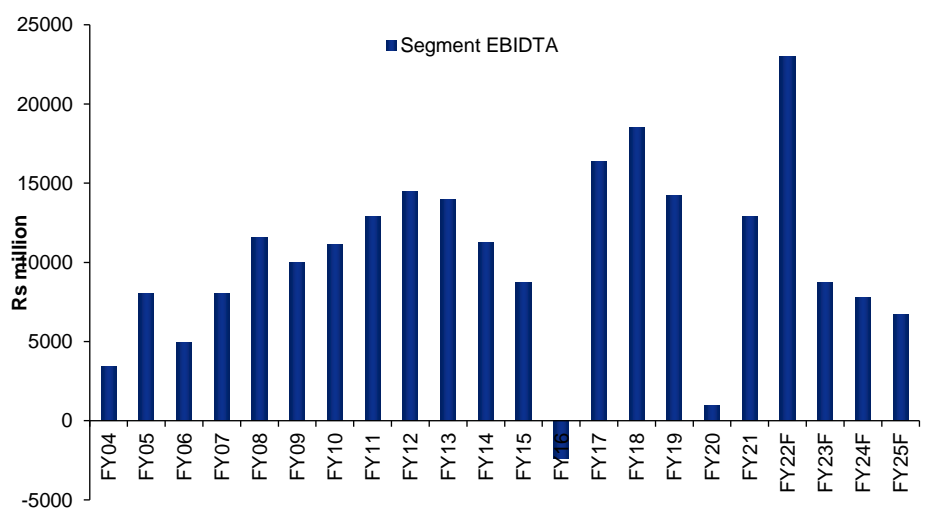
Figure 9: For the last year or so, South Asian naphtha-based ethylene margins have been highly volatile; as of now, most ethylene makers are losing money which doesn't bode well for GAIL's petchem margin



SOURCES: INCRED RESEARCH, IHSMARKIT

We expect segmental EBITDA for petchem business to decline in coming quarters ➤

Figure 10: As spreads fall with domestic APM prices on the rise, EBITDA of petchem business will decline

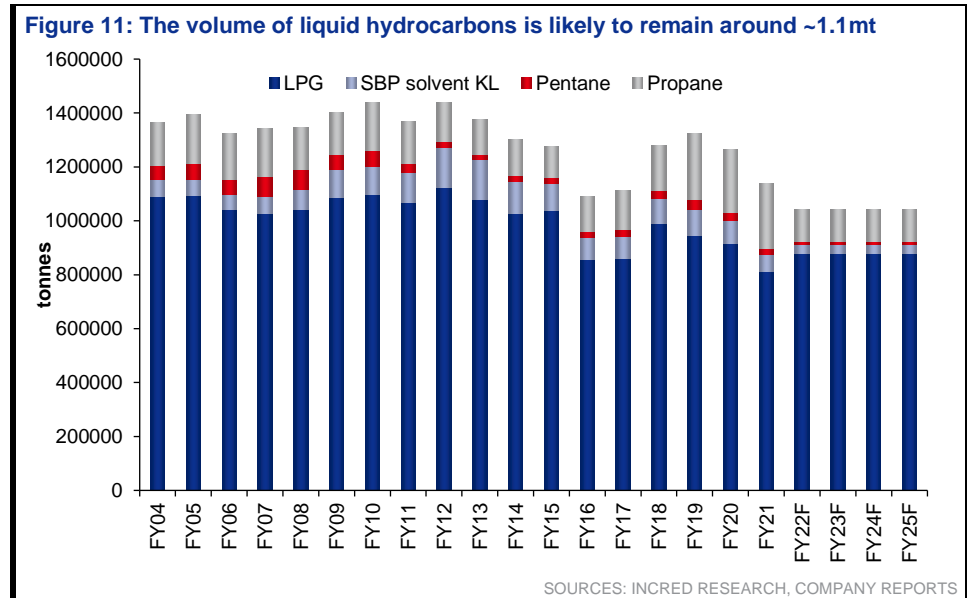


SOURCES: INCRED RESEARCH, COMPANY REPORTS

Liquid hydrocarbon business

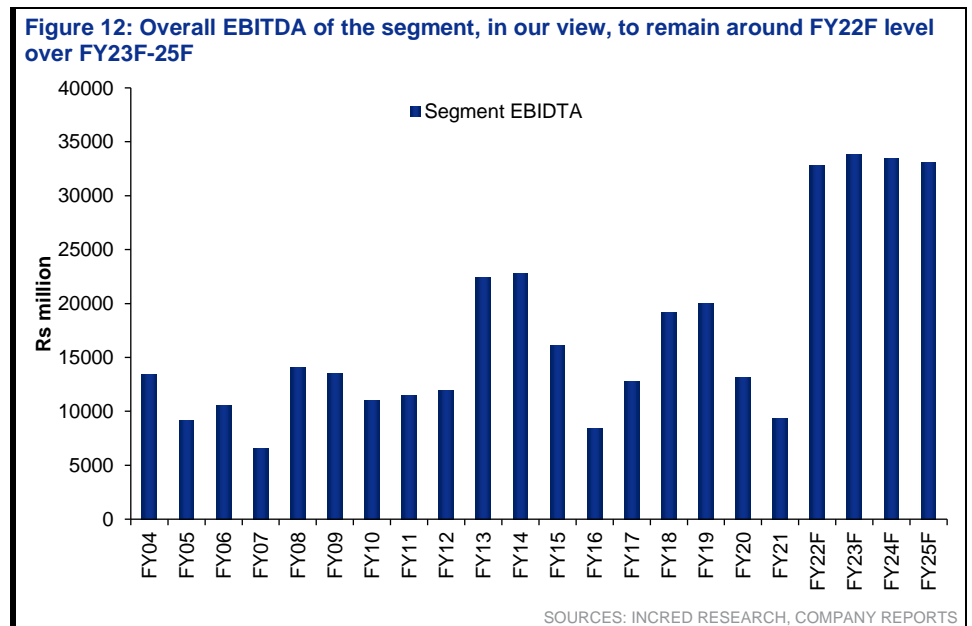
Liquid petroleum gas (LPG) is one of the main products in the liquid hydrocarbon business. Apart from LPG, GAIL makes SBP solvents as well as pentane and propane.

Overall liquid hydrocarbon production has been relatively stable over past few years ➤



We don't expect LPG price to follow international Brent crude price, discount to increase ➤

We expect government policies to ensure that overall EBITDA of the segment remains around FY22F level.

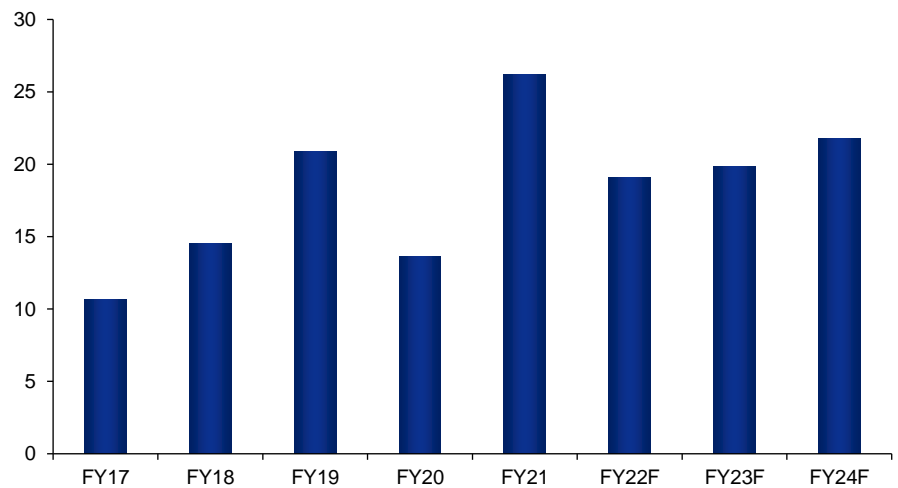


Earnings and valuation

We expect that after tremendous EPS growth likely in FY22F, EPS is set to decline in FY23F as we expect profitability in the trading business to fall, EBITDA of liquid hydrocarbon business to remain constant while petchem business can face headwinds because of lower ethylene margins globally. We expect EPS to decline at a 7% CAGR over the next three years to Rs18.90 in FY25F.

EPS to decline at a 7% CAGR over FY22F-25F ➤

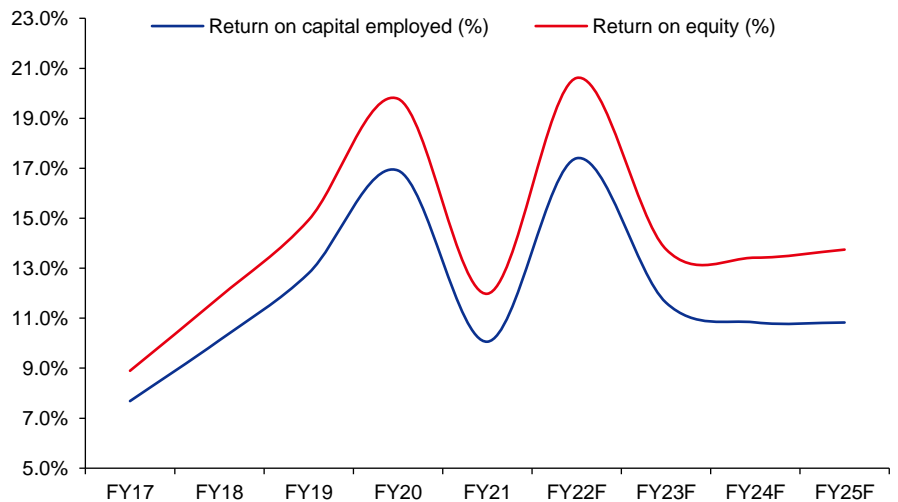
Figure 13: EPS to decline at a 7% CAGR over FY22F-25F



SOURCES: INCRED RESEARCH, COMPANY REPORTS

RoE and RoCE of the company to decline over FY22F-25F ➤

Figure 14: RoCE and RoE of the consolidated entity to decline over FY22F-25F



SOURCES: INCRED RESEARCH, COMPANY REPORTS

As of now, the consolidated entity trades at 10x one-year forward EPS ➤

Currently, the consolidated entity trades at 10x one-year forward EPS. P/E has already derated significantly, but we believe that petchem and trading businesses can lead to a further de-rating.

Figure 15: GAIL stock has already de-rated significantly and trades around 10x one-year forward EPS



SOURCES: INCRED RESEARCH, COMPANY REPORTS

However, we believe there is significant de-rating potential still left, and we value the stock at a 25% discount to historical mean ➤

We believe there is a significant de-rating potential still left as:

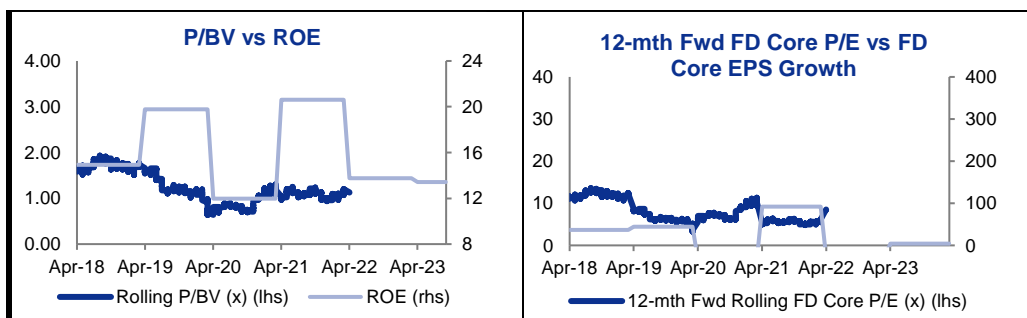
1. Petchem margins are likely to decline.
2. While we don't think there will be any decline in gas transmission volume, in fact it can increase as supply to urea-makers is slated to go up.
3. We could not find any risk mitigation policy details vis-a-vis trading business. While we forecast a Rs20bn EBITDA for this segment, don't be surprised if it becomes negative. The volatility in the market is very high and trading unhedged cargo is like walking on a thin edge.

We have valued GAIL at a 25% discount to its historical mean to arrive at our target price of Rs182. We downgrade the stock to Hold (from Add earlier).

Figure 16: We have valued GAIL at a 25% discount to its historical mean to arrive at our target price of Rs182; downgrade to Hold

Head	Value	Units
FY23F	19.08	Rs/Share
FY24F	19.82	Rs/Share
One year's forward EPS	19.82	Rs/Share
Mean P/E	12.30	x
Target P/E (25% discount)	9.23	x
Target price	182	Rs/Share

SOURCES: INCRED RESEARCH, COMPANY REPORTS

BY THE NUMBERS

Profit & Loss

(Rs mn)	Mar-20A	Mar-21A	Mar-22F	Mar-23F	Mar-24F
Total Net Revenues	725,084	573,719	1,058,417	1,250,838	1,329,895
Gross Profit	131,105	118,857	187,612	154,702	160,928
Operating EBITDA	90,250	72,438	149,245	114,472	118,731
Depreciation And Amortisation	(20,802)	(21,738)	(23,670)	(25,334)	(25,721)
Operating EBIT	69,448	50,700	125,575	89,137	93,009
Financial Income/(Expense)	(3,089)	(1,793)	(2,331)	(3,551)	(3,276)
Pretax Income/(Loss) from Assoc.	22,466	17,146	17,500	17,500	17,500
Non-Operating Income/(Expense)	15,464	11,202	11,412	6,775	7,060
Profit Before Tax (pre-EI)	104,289	77,255	152,156	109,861	114,294
Exceptional Items					
Pre-tax Profit	104,289	77,255	152,156	109,861	114,294
Taxation	(9,143)	(15,826)	(35,748)	(25,090)	(26,207)
Exceptional Income - post-tax					
Profit After Tax	95,146	61,429	116,408	84,771	88,087
Minority Interests	(926)	(65)	(65)	(65)	(65)
Preferred Dividends					
FX Gain/(Loss) - post tax					
Other Adjustments - post-tax					
Net Profit	94,220	61,364	116,343	84,706	88,022
Recurring Net Profit	94,220	61,364	116,343	84,706	88,022
Fully Diluted Recurring Net Profit	94,220	61,364	116,343	84,706	88,022

Cash Flow

(Rs mn)	Mar-20A	Mar-21A	Mar-22F	Mar-23F	Mar-24F
EBITDA	90,250	72,438	149,245	114,472	118,731
Cash Flow from Invt. & Assoc.	15,464	11,202	11,412	6,775	7,060
Change In Working Capital	9,928	41,343	3,563	(982)	(1,904)
(Incr)/Decr in Total Provisions					
Other Non-Cash (Income)/Expense	(24,707)	493	498	413	422
Other Operating Cashflow	3,458	(46,096)	(28,261)	(28,260)	(28,260)
Net Interest (Paid)/Received	(3,089)	(1,793)	(2,331)	(3,551)	(3,276)
Tax Paid	(9,143)	(15,826)	(35,748)	(25,090)	(26,207)
Cashflow From Operations	82,161	61,761	98,377	63,776	66,565
Capex	(106,501)	(70,210)	(61,470)	(110,796)	(72,550)
Disposals Of FAs/subsidiaries					
Acq. Of Subsidiaries/investments	(7,328)	26,963	7,500	7,500	7,500
Other Investing Cashflow					
Cash Flow From Investing	(113,829)	(43,247)	(53,970)	(103,296)	(65,050)
Debt Raised/(repaid)	46,878	9,611	(6,464)	57,409	28,764
Proceeds From Issue Of Shares					
Shares Repurchased		(10,463)			
Dividends Paid	(39,425)	(22,376)	(39,963)	(36,411)	(33,525)
Preferred Dividends					
Other Financing Cashflow					
Cash Flow From Financing	7,453	(23,228)	(46,427)	20,998	(4,760)
Total Cash Generated	(24,216)	(4,715)	(2,020)	(18,522)	(3,245)
Free Cashflow To Equity	15,210	28,124	37,943	17,889	30,280
Free Cashflow To Firm	(28,579)	20,306	46,738	(35,968)	4,791

SOURCES: INCRED RESEARCH, COMPANY REPORTS

BY THE NUMBERS...cont'd

Balance Sheet					
(Rs mn)	Mar-20A	Mar-21A	Mar-22F	Mar-23F	Mar-24F
Total Cash And Equivalents	12,502	24,932	40,412	39,390	53,645
Total Debtors	58,483	45,950	78,721	92,970	98,818
Inventories	31,830	29,897	35,009	40,735	43,675
Total Other Current Assets	47,805	36,286	36,286	36,286	36,286
Total Current Assets	150,620	137,065	190,428	209,381	232,424
Fixed Assets	499,592	550,892	590,695	678,159	726,991
Total Investments	98,930	125,892	133,392	140,892	148,392
Intangible Assets					
Total Other Non-Current Assets					
Total Non-current Assets	598,522	676,784	724,087	819,051	875,383
Short-term Debt					
Current Portion of Long-Term Debt					
Total Creditors	132,946	147,583	189,029	208,021	214,904
Other Current Liabilities					
Total Current Liabilities	132,946	147,583	189,029	208,021	214,904
Total Long-term Debt	69,115	78,726	72,262	129,671	158,435
Hybrid Debt - Debt Component					
Total Other Non-Current Liabilities					
Total Non-current Liabilities	69,115	78,726	72,262	129,671	158,435
Total Provisions	53,529	54,742	55,240	55,652	56,074
Total Liabilities	255,589	281,051	316,530	393,344	429,414
Shareholders Equity	492,683	531,823	597,011	634,114	677,418
Minority Interests	870	975	975	975	975
Total Equity	493,553	532,798	597,986	635,088	678,393

Key Ratios					
	Mar-20A	Mar-21A	Mar-22F	Mar-23F	Mar-24F
Revenue Growth	(4.8%)	(20.9%)	84.5%	18.2%	6.3%
Operating EBITDA Growth	(6.6%)	(19.7%)	106.0%	(23.3%)	3.7%
Operating EBITDA Margin	12.4%	12.6%	14.1%	9.2%	8.9%
Net Cash Per Share (Rs)	(12.55)	(11.94)	(7.17)	(20.33)	(23.60)
BVPS (Rs)	109.24	118.06	134.45	142.81	152.56
Gross Interest Cover	22.48	28.28	53.87	25.10	28.39
Effective Tax Rate	8.8%	20.5%	23.5%	22.8%	22.9%
Net Dividend Payout Ratio	36.8%	36.7%	38.2%	41.9%	37.8%
Accounts Receivables Days	28.25	33.22	21.50	25.05	26.32
Inventory Days	17.47	24.77	13.60	12.61	13.18
Accounts Payables Days	78.23	112.55	70.55	66.11	66.03
ROIC (%)	10.3%	7.4%	17.0%	10.4%	10.1%
ROCE (%)	14.8%	9.9%	20.1%	12.6%	11.9%
Return On Average Assets	13.6%	8.0%	13.7%	9.0%	8.5%

SOURCES: INCRED RESEARCH, COMPANY REPORTS

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Corporate Governance Report of Thai Listed Companies (CGR). CG Rating by the Thai Institute of Directors Association (Thai IOD) in 2021, Anti-Corruption 2021

ADVANC – Excellent, Certified, **AMATA** – Excellent, Certified, **ANAN** – Excellent, n/a, **AOT** – Excellent, n/a, **AP** – Excellent, Certified, **ASP** – Excellent, n/a, **AWC** – Excellent, Declared, **AU** – Good, n/a, **BAM** – Very Good, Certified, **BAY** – Excellent, Certified, **BBL** – Excellent, Certified, **BCH** – Very Good, Certified, **BCP** – Excellent, Certified, **BCPG** – Excellent, Certified, **BDMS** – Excellent, n/a, **BEAUTY** – Good, n/a, **BEM** – Excellent, n/a, **BH** – Good, n/a, **BJC** – Very Good, n/a, **BLA** – Very Good, Certified, **BTS** – Excellent, Certified, **CBG** – Very Good, n/a, **CGET** – n/a, n/a, **CENDEL** – Excellent, Certified, **CHAYO** – Very Good, n/a, **CHG** – Very Good, n/a, **CK** – Excellent, n/a, **COM7** – Excellent, Certified, **CPALL** – Excellent, Certified, **CPF** – Excellent, Certified, **CPN** – Excellent, Certified, **CPNREIT** – n/a, n/a, **CRC** – Excellent, Declared, **DELTA** – Excellent, Certified, **DDD** – Excellent, n/a, **DIF** – n/a, n/a, **DOHOME** – Very Good, Declared, **DREIT** – n/a, n/a, **DTAC** – Excellent, Certified, **ECL** – Excellent, Certified, **EGCO** – Excellent, Certified, **EPG** – Excellent, Certified, **ERW** – Very Good, Certified, **GFPT** – Excellent, Certified, **GGC** – Excellent, Certified, **GLOBAL** – Excellent, n/a, **HANA** – Excellent, Certified, **HMPRO** – Excellent, Certified, **HUMAN** – Good, n/a, **ICHI** – Excellent, Certified, **III** – Excellent, Declared, **INTUCH** – Excellent, Certified, **IRPC** – Excellent, Certified, **ITD** – Very Good, n/a, **IVL** – Excellent, Certified, **JASIF** – n/a, n/a, **JKN** – n/a, Certified, **JMT** – Very Good, n/a, **KBANK** – Excellent, Certified, **KCE** – Excellent, Certified, **KEX** – Very Good, Declared, **KKP** – Excellent, Certified, **KSL** – Excellent, Certified, **KTB** – Excellent, Certified, **KTC** – Excellent, Certified, **LH** – Excellent, n/a, **LPN** – Excellent, Certified, **M** – Very Good, Certified, **MAKRO** – Excellent, Certified, **MC** – Excellent, Certified, **MEGA** – Very Good, n/a, **MINT** – Excellent, Certified, **MTC** – Excellent, Certified, **NETBAY** – Very Good, n/a, **NRF** – Very Good, Declared, **OR** – Excellent, n/a, **ORI** – Excellent, Certified, **OSP** – Excellent, n/a, **PLANB** – Excellent, Certified, **PRINC** – Very Good, Certified, **PR9** – Excellent, Declared, **PSH** – Excellent, Certified, **PTT** – Excellent, Certified, **PTTEP** – Excellent, n/a, **PTTGC** – Excellent, Certified, **QH** – Excellent, Certified, **RAM** – n/a, n/a, **RBF** – Very Good, n/a, **RS** – Excellent, Declared, **RSP** – Good, n/a, **S** – Excellent, n/a, **SAK** – Very Good, Declared, **SAPPE** – Very Good, Certified, **SAWAD** – Very Good, n/a, **SCB** – Excellent, Certified, **SCC** – Excellent, Certified, **SCGP** – Excellent, Declared, **SECURE** – n/a, n/a, **SHR** – Excellent, n/a, **SIRI** – Excellent, Certified, **SPA** – Very Good, n/a, **SPALI** – Excellent, Certified, **SPRC** – Excellent, Certified, **SSP** – Good, Certified, **STEC** – Excellent, n/a, **SVI** – Excellent, Certified, **SYNEX** – Very Good, Certified, **TCAP** – Excellent, Certified, **THANI** – Excellent, Certified, **TIDLOR** – n/a, Certified, **TISCO** – Excellent, Certified, **TKN** – Very Good, n/a, **TOP** – Excellent, Certified, **TRUE** – Excellent, Certified, **TTB** – Excellent, Certified, **TU** – Excellent, Certified, **TVO** – Excellent, Certified, **VGI** – Excellent, Certified, **WHA** – Excellent, Certified, **WHART** – n/a, n/a, **WICE** – Excellent, Certified, **WORK** – Good, n/a.

- CG Score 2021 from Thai Institute of Directors Association (IOD)

- Companies participating in Thailand's Private Sector Collective Action Coalition Against Corruption programme (Thai CAC) under Thai Institute of Directors (as of August 5, 2021) are categorised into: companies that have declared their intention to join CAC, and companies certified by CAC.

Recommendation Framework

Stock Ratings

Definition:

Add	The stock's total return is expected to exceed 10% over the next 12 months.
Hold	The stock's total return is expected to be between 0% and positive 10% over the next 12 months.
Reduce	The stock's total return is expected to fall below 0% or more over the next 12 months.

The total expected return of a stock is defined as the sum of the: (i) percentage difference between the target price and the current price and (ii) the forward net dividend yields of the stock. Stock price targets have an investment horizon of 12 months.

Sector Ratings

Definition:

Overweight	An Overweight rating means stocks in the sector have, on a market cap-weighted basis, a positive absolute recommendation.
Neutral	A Neutral rating means stocks in the sector have, on a market cap-weighted basis, a neutral absolute recommendation.
Underweight	An Underweight rating means stocks in the sector have, on a market cap-weighted basis, a negative absolute recommendation.

Country Ratings

Definition:

Overweight	An Overweight rating means investors should be positioned with an above-market weight in this country relative to benchmark.
Neutral	A Neutral rating means investors should be positioned with a neutral weight in this country relative to benchmark.
Underweight	An Underweight rating means investors should be positioned with a below-market weight in this country relative to benchmark.