MANAGEMENT SPEAK

SSKI

INDIA RESEARCH

3 October 2007

BSE Sensex: 17329

ITC

Rs186

OUTPERFORMER

Bloomberg (ITC IN)

Mkt Cap: Rs700bn; US$17.5bn

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Amongst the top-tier consumer plays, ITC has always been our preferred investment vehicle vis-à-vis Hindustan Unilever. Our bullish stance emanates from ITC's robust business model backed by the management's appetite to take risks and build new growth edifices. While this is reflected in market capitalization of ITC growing 3x over FY02-06, the stock has underperformed the broader market in the last one year due to the overhang of VAT implementation on cigarettes. While the market has had a pessimistic outlook with an estimate of 5-10% volume decline, we maintained that volume decline will not be so steep and would be arrested towards the end of the fiscal year to negligible levels. The past six months have vindicated our stance. Post VAT implementation, volume decline in the first six months is estimated at ~3%.

We did a rain check with ITC's management on life post VAT, as also the company's growth agenda. Our take-away is in line with our long-held view on the business operations – the core business is resilient to near-term uncertainties (VAT), and growth drivers as indeed risk-appetite are well in place, thereby ensuring earnings deliverance. ITC has been creating building blocks in the last few years, which have now started yielding results. The stock trades at 18x FY09E earnings for a sustained 20% revenue CAGR over the next three years. With strong earnings traction and having passed through the acid test of the highest-ever price increase in cigarettes (20%), we expect the stock price to track the earnings growth. Maintain Outperformer with a target price of Rs211.

KEY TAKEAWAYS

- Impact on **cigarettes** not as adverse as expected by the broader market. We maintain our estimates of flat volume growth during the year. **Future 5-year CAGR @ 10%**
- ITC aggressively seeding the **foods portfolio**; Bingo heading towards a 15% market share in the Rs20bn salty snacks market and is well on its way to be a Rs5bn brand in the next 18 months. Many more product launches lined up (within the existing foods segments as also new businesses). Non-cigarettes FMCG business expected to break even by CY09. **Future 5-year CAGR @ 35%**
- Adding 1750 rooms in the **hotels** business over the existing 5500 rooms; 3900 five star rooms by CY09 (currently 2900). New properties lined up in Bangalore, Chennai, Hyderabad, Noida, Ahmedabad. **Future 5-year CAGR @ 20%**
- Adding 300,000tpa of capacity in **paper** business (including 100,000tpa of pulping capacity); **Future 5-year CAGR @ 15%**
- Home and personal product portfolio to be added over the next one year, personal products to start with. Strategy to straddle price points and segments
- New commodity addition decision in **agri** business would be dependent on the foods portfolio. **Future 5-year CAGR @ 20%**

➢ Cigarettes: Impact of VAT implementation on cigarettes volume

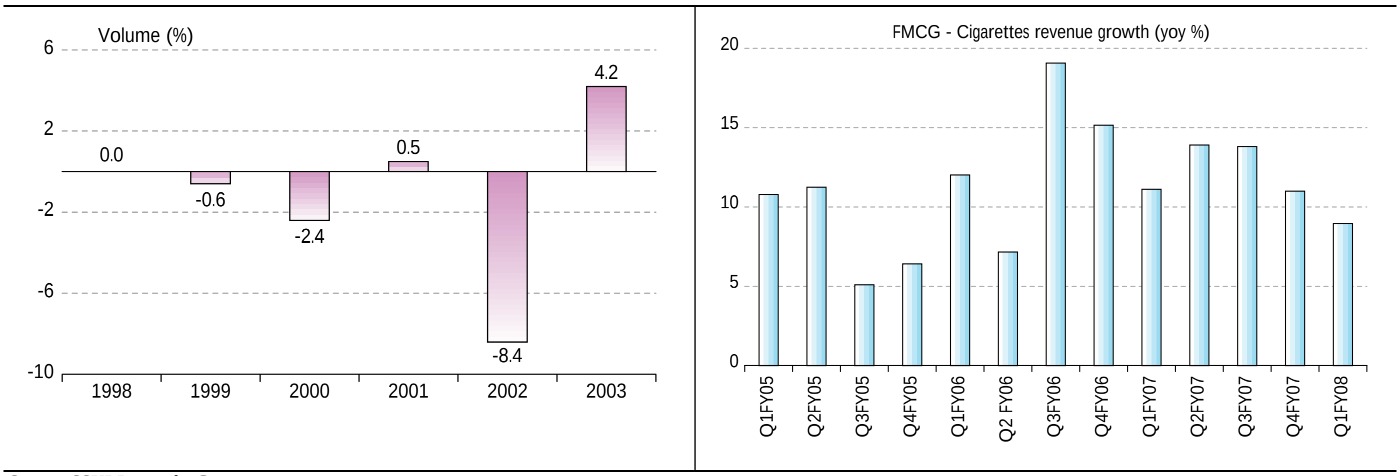
In the last one year, there has been a significant overhang of VAT implementation hitting the cigarettes business, which contributes 80% to profits. Uncertainty over this issue has led to stock underperformance in the last one year.

1. Impact so far: We find comfort in the fact that the impact on cigarette volumes is much less than expected by the broader market. We maintain that cigarettes volume decline was just ~2% in Q1FY08. With trade tax of 32.5% in Uttar Pradesh (UP) implemented at the end of the previous quarter, volume decline in Q2FY08 would be higher (~3-3.5%) than that in Q1FY08. In line with our expectations, ITC has recently managed to take a price hike of 20% with minimal impact on volumes.

2. 32.5% VAT in UP: The UP state government has levied a very high duty of 32.5% on cigarettes (12.5% for other states). Besides, most of the other states were a part of the Empowered Committee, which decided upon VAT, and had agreed on standard duty rates. While UP was not a part of the committee, we expect that VAT rates would be rationalized as cigarettes is one of the largest contributors to the state ex-chequer.

***Our take:* While the broader market estimated a 5-10% decline in volume, we have been the most optimistic and expected flat volumes. Unlike in 2001, this time we have been more convinced with ITC's ability to take price hikes given the underlying volume growth of 7% for the eight quarters preceding VAT implementation. We maintain our stance of flat volume growth in the current fiscal. As ITC has managed to take a price hike over and above the VAT, margins in the business are expected to improve by 75-100bp in FY08. We expect a 50bp margin improvement going forward.**

Cigarettes momentum – unlike in early 2000s, underlying growth momentum is stronger



Source: SSKI Research, Company

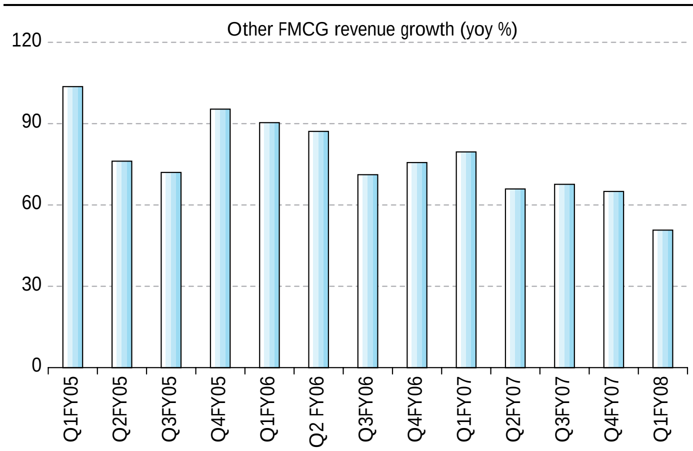
➢ Foods: ITC on its way to be the largest foods company in India within the next five years

ITC is emerging as one of the largest foods company in India with portfolio ranging from bakery, staples, confectioneries, RTE and newly added salty snack portfolio. While ITC is currently the largest player in branded staples – wheat flour and salt, under the brand *Aashirvaad* – it also commands a dominant position in the confectioneries space. One of the notable successes for ITC in the past three years has been the bakery business - *Sunfeast*. ITC's strategy of starting with the mass segment and now straddling all the price points in the biscuits business is showing results. ITC now accounts for 10-11% of the biscuits market and is working on increasing it to 15% in the next one year on the back of a few more launches lined up in the premium segments.

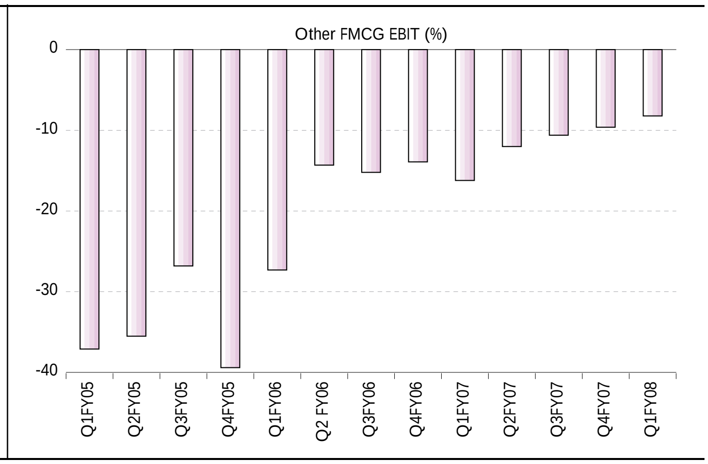
1. ***BINGO!*** – ITC has entered the Rs20bn salty snack market with a bang through its brand Bingo. Within six months of launch, ITC has managed to scale up the brand to 12-15% of market share in the regions where Bingo is launched. Given the dominance of Frito Lays in the space, the strong inroad made into the segment shows ITC's ability to penetrate the distribution chain. We believe that Bingo can potentially be a Rs5bn brand in the next 18-24 months. While leveraging ITC's existing grocery distribution channel, Bingo's launch has strengthened the product pipeline as indeed set the pace for ITC's planned new category addition.

2. ***When does the business turn profitable*** – ITC incurs Rs450m-500m of quarterly losses in the non-cigarettes FMCG business, substantial part of which is coming from foods portfolio. But notably, ITC has managed to sustain the extent of losses with revenues growing at over 50%. This indicates that while the earlier businesses are turning profitable, ITC continues to invest into new product launches. We believe that ITC's staples and confectioneries business has started contributing to the bottom-line, while biscuits business would take another 3-4 quarters to break even. We believe that as ITC introduces newer products under the processed foods segment, the business would continue to bleed.

Other FMCG – while the growth is consistently at over 50%...



...loss margins are dipping sharply



Source: SSKI Research, Company

3. ***Willingness to bleed:*** Rather than get worried on the losses in the business, we like the fact that ITC has the appetite and willingness to bleed in the long-gestation foods business, and thereby make it even more difficult for competition to enter the market. ITC has also demonstrated the appetite to seed the market, given the long-term potential in the space, e.g. Kitchens of India. We expect ITC's foods business to break even by the end of CY09.

***Our take:* We are confident of ITC's foods business growing at over 50% for the next couple of years and register 35% CAGR over the next five years, as it extends its market share in the existing segments and adds newer categories. ITC would also continue to push more products through the pipe. Besides extending its presence in the bakery and the recently-entered salty snack segments, ITC could also potentially look at new attractive segments. ITC has shown willingness to take an inorganic route of entry.**

➢ Other FMCG: Stationery and HPC business to drive growth; greetings business is a laggard

1. ***Stationery and greetings:*** ITC's ~Rs1bn stationery business, with brands like *Paper Kraft and Classmate*, looks a promising business segment. Given the strong momentum in the stationery business, ITC plans to add 100,000tpa of capacity by May 2008 and is aiming to double the size of the business in the next two years. However, given the slowdown in the greetings industry as consumer preferences shift to web model, we see limited growth potential in ITC's greetings and gifting business under the brand Expressions.

2. ***Lifestyle retailing:*** Retail business, under the brand Wills Lifestyle, accounts for ~15% of ITC's non-cigarettes FMCG business revenues. Having presence through 175 exclusive stores and over 1,500 multi branded outlets, ITC's lifestyle retailing brands – John Players and Wills Lifestyle – are growing at over 25%. While John Players is growing at over 30%, ITC may look at new initiatives in Wills Lifestyle to push up sales from its existing levels of 20%. However, we believe that this segment would continue to bleed for the next three years. ITC is also focusing on the exports market, wherein it utilizes the infrastructure of Wills Lifestyle to offer manufacturing and designing services to global brands.

3. ***Home and personal care segment:*** ITC has lined up a foray into the Rs150bn home and personal care segment, with entry into personal care segment expected soon. While ITC would initially look at product categories like shampoos, skin care and soaps, we expect the company to straddle segments and price points. Given ITC's deep distribution, we believe it could be a strong force to contend with in the home and personal care segment.

Our view: Within the non-cigarettes FMCG space, HPC business looks the most promising besides foods and stationery. We expect the business to register 25% + CAGR over the next five years, with additional upside from success in the HPC business.

➢ Hotels: Capex-driven growth; 20% CAGR expected over the next five years

ITC Hotels is currently the second largest hotels company in India, only next to Tata Group's Indian Hotels. ITC currently has capacity of 5,500 rooms including 2,900 5-star rooms. ITC, with lucrative properties and aggressive expansion plans (organic as well as inorganic), is well placed to capitalize upon India's booming hotel and hospitality industry.

1. ***Expansion on cards – focus on luxury segment:*** ITC plans to scale up its 5-star room capacity by 1,000 rooms to 3,900 and add a few properties under Fortune, besides increasing the properties under management contract. While construction at Chennai and Bangalore properties is already underway, ITC has bought land in Hyderabad, Ahmedabad and Noida. ITC also plans to add properties in Kolkatta and Gurgaon, besides potentially doubling the capacity of Sonar Bungalow and looking at a few property acquisitions. ITC has lined up capital expenditure of Rs15bn for the hotels business over the next three years.

2. While ITC is currently not eyeing the economy segment (like Ginger), it would look at the potential in tier-2 cities going forward.

3. ITC is also open to taking the inorganic route, mainly in the domestic market, to grow in the hotels business.

4. ***Hotels business – in a sweet spot:*** With the economy consistently growing at over 8% and the increasing pace of foreign traffic, the Indian hotel industry is in a sweet spot. With occupancy levels maintained at over 60% and ARRs in key cities like Mumbai, Delhi, Bangalore and Hyderabad matching the ARRs in Singapore and New York, Indian hotels industry is set to maintain its high growth momentum. Further triggered by Commonwealth Games in 2010, we are confident of 15% CAGR for India's hotel industry over the next five years.

5. ***Returns profile:*** The returns in ITC's hotels business would remain range bound, and we do not expect any material expansion in margins going forward. This can be attributed to the fact that returns profile in the key properties of Mumbai, Bangalore and Kolkatta is nearing maturation and new properties call for higher capital commitment (high cost of land acquisition).

***Our view:* We expect 20% CAGR for ITC's hotels business over the next five years, with a spurt in growth in FY09-11, when the new properties commence operations.**

➢ Agri-business: Synergies with foods business. Expect 20% CAGR over the next five years

ITC is one of the largest organized players in the agri space. ITC has one of the most efficient and innovative agri procurement channels through e-Choupals, which reaches out to 33,000 villages through 6,500 kiosks. ITC continues to dominate leaf tobacco and wheat trading and is the second largest procurer of soya in India.

1. ***Agri procurement – integration with foods portfolio:*** Growth strategy for ITC in the agri business would be driven by its ability to integrate its operations with the foods business. While ITC trades in agri commodities, addition of new commodities would be governed by its captive consumption in foods business. Around 60% of the leaf tobacco procured is for captive consumption, while 100% of the wheat procured is used by its bakery and staples business.

2. With ITC entering the salty snacks business, ITC would now target the potato procurement opportunity. Other attractive segments, wherein ITC would be looking at integration with the foods business, include soya and maize procurement. We see immense merit in the strategy, as it assures a minimum scale for ITC's agri business while simultaneously helping ITC save on procurement as also be assured of quality in the foods business.

3. According to the various state regulations, ITC pays the regular trading fees as per APMC.

4. Margins profile in the business would improve marginally. However, ITC would continue to focus on creating scale.

5. **ITC is experimenting with its format** – Choupal Fresh – and has entered into a strategic alliance with Pantaloon Retail to manage its fruits and vegetables procurement and sales at Food Bazaar. We see substantial scale-up potential in this format. However, we believe ITC would wait for the dust to settle down as regards to political opposition against organized retailers in food products.

***Our view:* Agri operations are expected to register 20% + CAGR over the next five years. While it would not be a major profit contributor, the business has immense strategic relevance to the foods operations. We also believe that ITC can potentially scale up the business for managing direct procurement for organized retailers.**

➢ Paper: Capex-driven growth – 300,000tpa of capacity addition; margin improvement driven by product mix improvement and backward integration

ITC is one of the leading players in the paperboard and specialty paper business in India. With existing capacity nearing optimum utilization, future growth would be driven by improved product mix and capacity addition.

1. *ITC has lined up 300,000tpa of capacity addition with 100,000tpa of pulp mill capacity expected to be operational by end of FY08, 110,000tpa of stationery paper machine by Q1FY09 and value added paperboard capacity of 90,000tpa by Q2FY09.*

2. Pulp mill capacity would be a backward integration to the paper business and help improve margins and substitute hardwood imports. ITC is adding the stationery machine capacity to back the rapid growth in stationery business.

3. While the overall paper industry is growing at 8%, value added paper segment is growing much faster at 20%+.

Our view: ***We believe ITC's paper business is well placed to register 15% CAGR over the next five years. Margins in the business would improve on the back of a better product mix and backward integration. However, margin expansion would be subdued in the near term as pulping capacity becomes operational before the paper and value added paper division.***

Income statement

Year to March (Rs m)	FY05	FY06	FY07	FY08E	FY09E
Net sales	**76,395**	**97,905**	**123,693**	**145,375**	**174,240**
% growth	*18.1*	*28.2*	*26.3*	*17.5*	*19.9*
Operating expenses	48,438	64,578	84,055	100,554	119,880
EBITDA	**27,956**	**33,327**	**39,638**	**44,820**	**54,360**
% growth	*18.2*	*19.2*	*18.9*	*13.1*	*21.3*
Other income	2,358	2,861	3,365	3,780	4,356
Net interest	(455)	(173)	(107)	(147)	(142)
Depreciation	3,129	3,323	3,629	4,156	4,430
Pre-tax profit	**26,731**	**32,692**	**39,267**	**44,296**	**54,144**
Deferred Tax	-	-	-	-	-
Current Tax	8,360	9,888	12,267	13,893	16,404
Profit after tax	18,370	22,804	27,000	30,404	37,740
Preference dividend	-	-	-	-	-
Non-recurring items	-	-	-	-	-
Net profit after non-recurring items	**18,370**	**22,804**	**27,000**	**30,404**	**37,740**
% growth	*15.3*	*24.1*	*18.4*	*12.6*	*24.1*

Balance sheet

Year to March (Rs m)	FY05	FY06	FY07	FY08E	FY09E
Paid-up capital	2,494	3,756	3,762	3,762	3,762
Preference share capital	-	-	-	-	-
Reserves & surplus	76,462	86,860	100,609	118,769	143,323
Total shareholders' equity	78,956	90,615	104,371	122,531	147,086
Total current liabilities	30,338	35,781	38,576	41,030	43,784
Total Debt	2,454	1,197	2,009	2,009	2,009
Deferred tax liabilities	3,761	3,248	4,729	4,729	4,729
Other non-current liabilities	-	-	-	-	-
Total liabilities	36,553	40,226	45,313	47,767	50,521
Total equity & liabilities	**115,509**	**130,841**	**149,684**	**170,298**	**197,607**
Net fixed assets	41,369	44,051	56,109	66,953	73,862
Investments	38,747	35,170	30,678	25,678	21,678
Total current assets	35,393	51,619	62,897	77,668	102,067
Deferred tax assets	-	-	-	-	-
Other non-current assets	-	-	-	-	-
Working capital	5,055	15,839	24,321	36,638	58,284
Total assets	**115,509**	**130,841**	**149,684**	**170,298**	**197,607**

Cash flow statement

Year to March (Rs m)	FY05	FY06	FY07	FY08E	FY09E
Pre-tax profit	26,731	32,692	39,267	44,296	54,144
Depreciation	3,129	3,323	3,629	4,156	4,430
chg in Working capital	(5,312)	(2,782)	(8,040)	(2,247)	(3,240)
Total tax paid	(8,360)	(9,888)	(12,267)	(13,893)	(16,404)
Ext ord. Items	-	-	-	-	-
Operating cash Inflow	16,187	23,345	22,589	32,313	38,930
Capital expenditure	(8,777)	(5,382)	(15,299)	(15,000)	(11,339)
Free cash flow (a+b)	7,410	17,964	7,291	17,313	27,591
Chg in investments	22,332	3,577	4,492	5,000	4,000
Debt raised/(repaid)	1,245	(1,256)	812	-	-
Capital raised/(repaid)	884	664	424	(0)	(0)
Dividend (incl. tax)	-	-	-	-	-
Misc	(1,115)	(12,946)	(12,575)	(12,243)	(13,185)
Net chg in cash	30,756	8,002	443	10,070	18,406

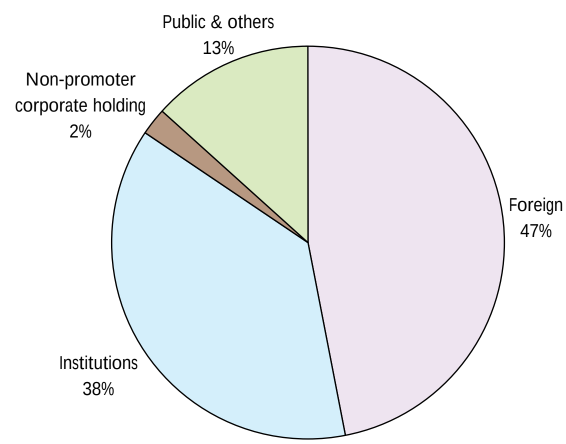
Key ratios

Year to March	FY05	FY06	FY07	FY08E	FY09E
EBITDA margin (%)	36.6	34.0	32.0	30.8	31.2
EBIT margin (%)	32.5	30.6	29.1	28.0	28.7
PAT margin (%)	24.0	23.3	21.8	20.9	21.7
RoE (%)	25.7	26.9	27.7	26.8	28.0
RoCE (%)	32.8	33.3	34.9	33.8	35.3
Gearing (x)	0.0	(0.1)	(0.1)	(0.1)	(0.2)

Valuations

Year to March	FY05	FY06	FY07	FY08E	FY09E
Reported EPS (Rs)	4.9	6.1	7.2	8.1	10.0
Adj. EPS (Rs)	4.9	6.1	7.2	8.1	10.0
PER (x)	38.9	31.4	26.6	23.6	19.0
Price/Book (x)	9.0	7.9	6.9	5.9	4.9
EV/Net sales (x)	9.4	7.2	5.7	4.8	3.9
EV/EBITDA (x)	25.6	21.3	17.9	15.6	12.6
EV/CE (x)	8.4	7.5	6.4	5.4	4.4

Shareholding pattern



As of June 2007

SSKI INDIA

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Explanation of Ratings:

1. Outperformer: More than 10% to Index
2. Neutral: Within 0-10% to Index
3. Underperformer: Less than 10% to Index

Disclosure of interest:

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