CREDIT SUISSE

ITC Ltd

(ITC.BO / ITC IN)

INITIATION

Steady growth, low expectations

Rating	**OUTPERFORM***
Price (23 Jul 07)	153 (Rs)
Target price	188 (Rs)[1]
Chg to TP (%)	22.5
Mkt cap (Rs mn)	576,561 (US$ 14,367)
Enterprise value (Rs mn)	541,049
Number of shares (mn)	3,762.22
Free float (%)	67.93
52-week price range	194.50 - 140.95

** Stock ratings are relative to the relevant country index*
[1] Target Price is for 12 months

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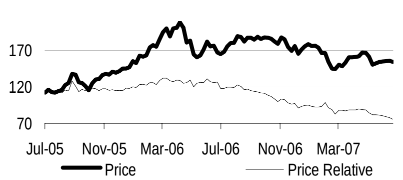
- **Event:** We initiate coverage on ITC with an OUTPERFORM rating and a target price of Rs188, which implies 22% potential upside**.**
- **View:** ITC's cigarette profits tend to grow even in an adverse tax environment. Furthermore, net price realisations tend to outpace volume falls in a declining market, resulting in net sales growth. However, total costs fall, as most costs are linked to sales volume, resulting in margin expansion. ITC has effected a price rise of some 20%, which should result in about a 9.4% rise in net realisations. We expect EBIT margins from cigarettes to increase 150 bp and absolute EBIT to grow 6% in FY08E, resuming double-digit growth thereafter (10.5% p.a. from FY08-10E). Paper should benefit from pulp capacity expansion, while supply-demand in the hotel business remains conducive to profitable growth. Its foods business is likely to turn profitable by early FY09, although entry into the HPC business is expected to drag down segmental profitability. We expect EPS to grow 14.8% p.a. from FY07-10E and ROE to remain steady at about 25%, despite high investments.
- **Catalyst:** In our view, the market is excessively focused on short-term volume growth in cigarettes, or the lack of it, and would be positively surprised by segmental profit growth. We believe that consensus is for underestimating the extent of a net realisation rise in the cigarette business.
- **Valuation:** ITC has underperformed the market by 41% in the past 12 months and now trades at 19.3x FY08E, which is at a 10% premium to the broader market. We set a sum-of-the-parts (SOTP) fair value of Rs188, based on Rs110 for cigarettes (16.5x FY09E cigarette earnings). Key risks comprise a further cigarette tax hike and cyclicality in other businesses.

Share price performance



The price relative chart measures performance against the BOMBAY SE 30 SHARE SENSITIVE index which closed at 15732.2 on 23/07/07
On 23/07/07 the spot exchange rate was Rs40.13/US$1

Performance over	1M	3M	12M
Absolute (%)	-0.5	-2.0	-8.3
Relative (%)	-8.5	-13.2	-41.2

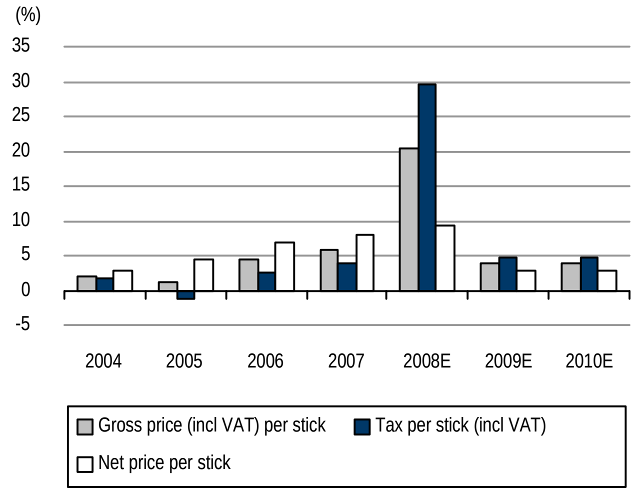
Financial and valuation metrics

Year	3/07A	3/08E	3/09E	3/10E
Revenue (Rs mn)	123,138.3	139,590.9	163,410.6	187,971.8
EBITDA (Rs mn)	39,736.4	43,357.3	51,205.5	59,215.6
EBIT (Rs mn)	36,107.2	39,210.1	46,360.2	53,672.3
Net income (Rs mn)	26,999.7	29,886.4	34,976.1	40,479.8
EPS (CS adj., Rs)	7.09	7.94	9.30	10.76
- change from prev. EPS (%)	n.a.	0.0	0.0	0.0
- consensus EPS	n.a.	8.19	9.29	
EPS growth (%)	18.6	12.1	17.0	15.7
P/E (x)	21.6	19.3	16.5	14.2
Dividend yield (%)	2.0	2.1	2.6	2.9
EV/EBITDA (x)	13.9	12.5	10.4	8.7
P/B (x)	5.5	4.8	4.2	3.6
ROE (%)	25.5	24.9	25.5	25.6
Net debt/equity (%)	net cash	net cash	net cash	net cash

Source: Company data, Thomson Financial Datastream, Credit Suisse estimates

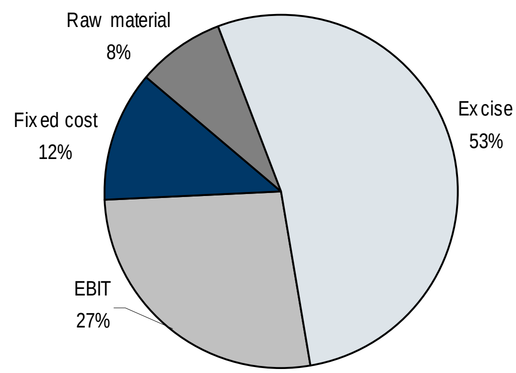
Focus charts

Figure 1: **Cigarettes: pricing power is high …**



Source: Company data, Credit Suisse estimates

Figure 2: **… and costs independent of price ...**



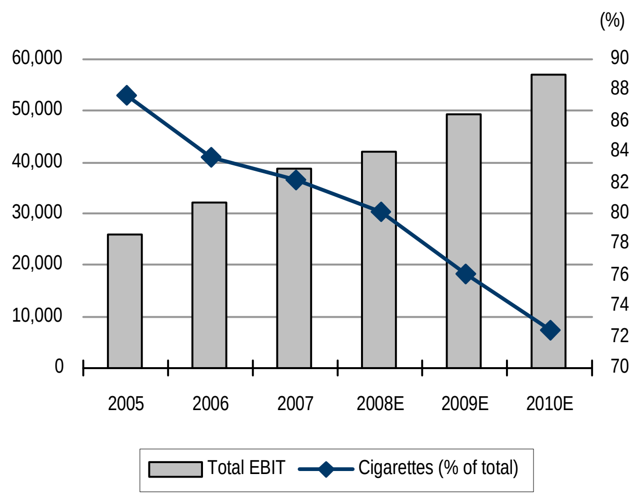
Source: Company data, Credit Suisse estimates

Figure 3: **… therefore, profits are very sensitive to price**

		Volume					
		-2%	**-4%**	**-6%**	**-8%**	**-10%**	**-12%**
Gross price	**14%**	-9.4	-12.3	-15.2	-18.1	-21.0	-23.9
	16%	-2.4	-5.4	-8.4	-11.5	-14.5	-17.5
	18%	4.7	1.5	-1.7	-4.9	-8.0	-11.2
	20%	11.7	8.4	5.1	1.8	-1.6	-4.9
	22%	18.8	15.3	11.8	8.4	4.9	1.4
	24%	25.8	22.2	18.6	15.0	11.4	7.8
	26%	32.9	29.1	25.4	21.6	17.9	14.1

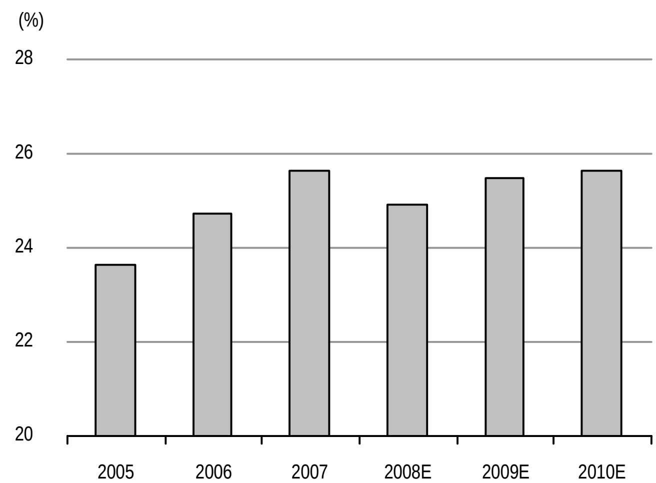
Source: Company data, Credit Suisse estimates

Figure 4: **Cigarette contribution to EBIT is falling …**



Source: Company data, Credit Suisse estimates

Figure 5: **… but ROE is likely to be maintained**



Source: Company data, Credit Suisse estimates

Steady growth, low expectations

Cigarettes: focus on profit, not volume growth

ITC's profits from its cigarette business tend to grow, even in an adverse tax environment

ITC's profits from cigarettes tend to grow even in an adverse tax environment. Furthermore, net price realisations (net of all taxes) tend to outpace volume falls in a declining market, resulting in net sales growth. However, total costs fall, as most costs are linked to volume of sales, resulting in margin expansion. ITC has effected a price increase of ~20%, which effectively results in about a 9.4% increase in net realisations. EBIT should grow as long as volume decline is contained below 10%. We expect EBIT margins from cigarettes to increase 150 bp and absolute EBIT to grow 6% in FY08E, and resume double-digit growth thereafter (10.5% p.a. in FY08-10E).

The cigarette industry has grown at 1.9% p.a. in volume terms in the past 15 years, despite an unfavourable tax regime supporting other tobacco consumption. In gross value terms, the industry has grown at ~10% p.a. in the same period (roughly in line with growth in personal finance consumption expenditure (PFCE). We expect trend growth rates to shift up, as the economy grows faster, already evidenced in volume growth of 5.3% in the past five years. The recent imposition of VAT is likely to result in a temporary decline in volumes (-6% in FY08E), in our view. ITC's positioning in cigarettes is solid, with a predominant market share of 72% in the domestic market (and a much higher value share). The dominance is set to rise, as ITC has the best brand recognition, distribution, and its portfolio of products straddles every possible price point. Competition from international brands is negligible and is likely to remain so for the time being.

Other businesses progressing well

ROE maintained at c25% despite investment in other businesses.

ITC has chosen to invest cash flows from its cigarette business into long-gestation businesses, such as hotels and paper, rather than paying out high dividends. Businesses other than tobacco, which by nature earns a much lower return, account for 76% of capital employed. Despite this, ITC has successfully cross-leveraged strengths in various businesses to ensure firm levels of ROE stay at a very healthy 25% or so.

We expect hotel revenues to grow 23% p.a. in FY07-10E, as the supply-demand scenario remains favourable. The paper business (+14% p.a.) is likely to benefit from a rise in in-house pulp capacity in FY08 and paper/paper board capacity in FY09. The foods business is likely to break even in early FY09, which would coincide with entry into soaps and personal products. Overall, we expect businesses other than cigarettes, to grow EBIT at 32% p.a. in FY07-10E (and contribute 28% of EBIT by FY10E, up from 18% in FY07).

Valuation not factoring in execution capability

Trading at its lowest premium to the market

ITC's net profits have grown 21% p.a. in the past ten years and for any three-year period in the interim, its net profit has grown at least 16.5% p.a. (despite entry into long gestation projects and various unfavourable tax measures). The recent under performance leads us to believe that the market is underestimating the managements' capability to deliver strong results in times of adverse regulatory actions. We expect EBITDA to grow 14.2% p.a. and earnings to grow 15% p.a. in FY07-10E.

We value ITC on an SOTP basis and set a target price of Rs188, valuing the cigarette business at Rs110 (16.5x FY09E, in line with the average multiple of global peers). We believe that the market is excessively focused on short-term volume growth in cigarettes, or the lack of it, and will be positively surprised by segmental profit growth. At our target price, ITC trades at 20.2x FY09E, in line with its 17-year average, while market multiples have moved up significantly. ITC trades at its lowest historical premium to the broader market, though the stable characteristics of its earnings profile remains intact. As a result, we have an OUTPERFORM rating on the stock. Key risks comprise further tax increases, FDI in cigarettes and a cyclical downturn in other businesses.

Financial summary

Figure 6: **Summary P&L**

Year-end 31 Mar (Rs mn)	2005	2006	2007	2008E	2009E	2010E
Cigarette volume (mn)	69,998	75,894	81,265	76,389	81,736	86,641
Growth (%)	*7.1*	*8.4*	*7.1*	*-6.0*	*7.0*	*6.0*
Gross cigarette sales	99,964	113,229	128,244	128,988	143,538	158,236
Paper & packaging	9,768	11,450	12,632	13,557	16,748	18,668
Hotels	5,729	7,778	9,787	11,744	14,680	18,351
Agribusiness	12,072	19,273	26,604	31,396	37,058	42,242
Other FMCG	6,069	10,635	17,933	25,195	31,585	39,642
Total gross sales	133,601	162,364	195,200	210,880	243,610	277,139
Less: excise duty	57,546	64,381	72,062	71,289	80,200	89,167
Net sales	**76,056**	**97,983**	**123,138**	**139,591**	**163,411**	**187,972**
Growth (%)	*18.6*	*28.8*	*25.7*	*13.4*	*17.1*	*15.0*
Raw materials consumed	27,757	39,910	53,294	62,959	75,179	87,525
Other operating costs	20,773	24,8016	30,136	33,275	37,026	41,232
Operating profit	**27,526**	**33,272**	**39,708**	**43,357**	**51,205**	**59,216**
Operating margin (%)	36.2	34.0	32.2	31.1	31.3	31.5
Growth (%)	*16.6*	*20.9*	*19.3*	*9.2*	*18.1*	*15.6*
Interest expense	424	118	177	89	44	22
Depreciation	3,129	3,323	3,629	4,147	4,845	5,543
Other income	2,358	2,861	3,365	4,192	4,374	5,016
Profit before tax	26,331	32,692	39,267	43,313	50,690	58,666
Extraordinary items	4,859	(63)	363	0	0	0
Taxation	9,276	10,276	12,631	13,427	15,714	18,186
Profit after tax	**21,914**	**22,354**	**27,000**	**29,886**	**34,976**	**40,480**
Net margin (%)	28.8	22.8	21.9	21.4	21.4	21.5

Source: Company data, Credit Suisse estimates

Figure 7: **Summary balance sheet**

Year-end 31 Mar (Rs mn)	2005	2006	2007	2008E	2009E	2010E
Share capital	2,482	3,755	3,762	3,762	3,762	3,762
Reserves and surplus	76,474	86,860	100,609	116,189	133,558	154,230
Total loans	2,454	1,197	2,009	1,684	1,664	1,644
Sources of funds	**81,410**	**91,812**	**106,380**	**121,636**	**138,985**	**159,637**
Gross block	57,463	62,272	71,343	83,343	95,343	107,343
Less: depreciation	17,955	20,654	23,895	28,043	32,888	38,431
Net block	39,508	41,617	47,448	55,300	62,455	68,912
Total investments	38,747	35,170	30,678	48,464	57,757	70,858
Current assets, loans & adv.	35,393	51,619	62,897	58,163	66,084	74,418
Current liabilities	30,338	35,781	38,576	44,224	51,244	58,485
Net current assets	1,294	12,591	19,593	9,210	10,112	11,205
Application of funds	**81,410**	**91,812**	**106,380**	**121,636**	**138,985**	**159,637**

Source: Company data, Credit Suisse estimates

Cigarettes: focus on profit growth

We expect EBIT margins from cigarettes to increase 150 bp, and absolute EBIT to grow 6% in FY08E

ITC's profits from cigarettes tend to grow even in an adverse tax environment. Net price realisations (net of all taxes) tend to outpace volume falls in a declining market, resulting in growth in net sales. However, total costs fall, as most costs are linked to volume of sales, resulting in margin expansion. ITC has effected a price increase of around 20%, which should effectively result in about a 9.4% increase in net realisations. EBIT is likely to grow as long as volume decline is contained below 10%. We expect EBIT margins from cigarettes to increase 150 bp and absolute EBIT to grow 6% in FY08E, resuming double-digit growth thereafter (10.5% p.a. in FY08-10E).

The cigarette industry has grown at 1.9% p.a. in volume terms in the past 15 years, despite an unfavourable tax regime that supports other forms of tobacco consumption. In gross value terms, the industry has grown at around 10% p.a. in the same period (roughly 0.75x nominal GDP growth). We expect trend growth rates to shift upwards, as the economy grows faster, already evidenced in the recent past (volume growth of 5.3% in the past five years). The recent imposition of VAT is likely to result in a temporary decline in volumes of 6% in FY08E, in our view. ITC's positioning in cigarettes is solid, with a predominant market share of 72% in the domestic market (and a much higher value share). This dominance is set to increase, as ITC has the best brand recognition, distribution and portfolio of products, and straddles every possible price point. Competition from international brands is negligible and is likely to remain so until foreign direct investment in cigarette manufacture is allowed.

Unique cost structure

ITC's cost structure is unique and distinct from other consumer companies' cost structures. Net realisations represent only about 46% of the selling price to consumers (about 42% post-imposition of VAT). The bulk of the tax is specific per-stick duty (except the recently introduced VAT), unlike the ad-valorem tax on other consumer goods. Raw material costs are a fraction of the excise paid, rendering duty credits meaningless. Fixed costs are negligible, as compared to the selling price. Profitability is high relative to most other industries. Given the nature of its cost structure and competitive dynamics, the margins are almost solely a function of pricing action. Volumes have very little bearing on margins in the short to medium term.

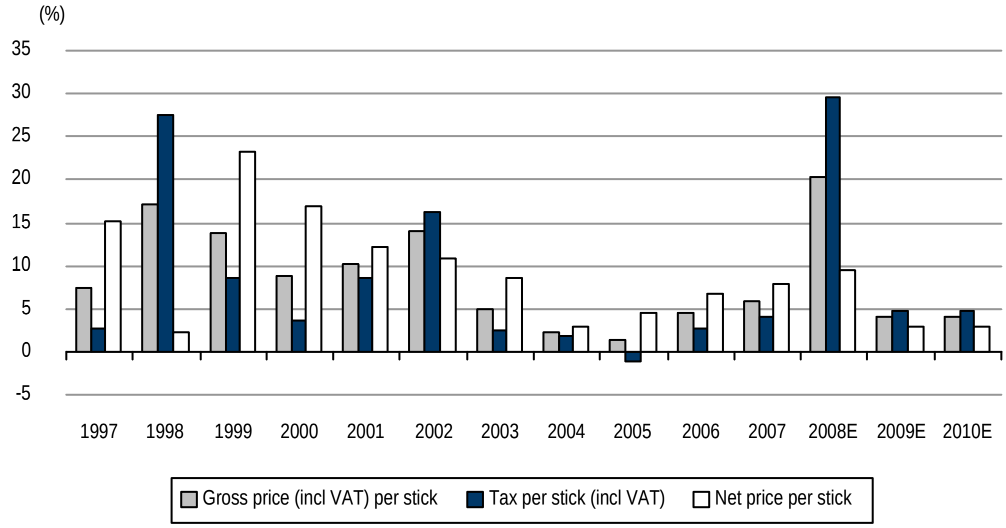
Price increases have a whole different significance, due to the nature of taxation

Margins are almost solely a function of pricing action

Excise duty on cigarettes is levied on a per-stick, rather than an ad valorem, basis. Therefore, excise duty paid depends primarily on volume growth and mix change (specific rates differ across various sub-segments). Since net price is a fraction of the gross price (about 0.46x), any variation in net prices is magnified at the net realisation level. A simple analysis of historic data suggests that ITC tends to increase gross prices by at least as much as the increase in excise duty in percentage terms. This is a key reason why ITC's net realisations have almost always increased in the past few years.

ITC's pricing power is very large, in our view. The average increase in specific excise duty in the past 15 years has been about 5-6% p.a., in line with WPI inflation (5.78% p.a. over the same period). Net realisation has increased in every single year of this period, indicative of the massive pricing power in this business. In fact, net price increases tend to outpace volume declines, resulting in net sales growth even in years' of sharp tax/ price increases.

Figure 8: **Increase in net selling price in every year**



Note: Tax includes VAT

Source: Company data, Credit Suisse estimates

Volume-dependent cost structure

Excise duty is the biggest component of a cigarette business' costs and is linked to volume and mix of sales. Raw material costs are variable and linked to the volume of sales (and price of raw materials) and to a lesser extent, the mix of sales. ITC's other costs, including fixed costs, are extremely low at 12.5% of gross sales and about 27% of net sales (see Figure 9: Unique cost structure). In fact, prior to the imposition of VAT, only commissions and discounts (less than 1% of net sales) were linked to the value of sales and therefore to the price of products. Not surprisingly, ITC's profits are far more sensitive to increases in the net price than to increases in volumes sold. For every 1% increase in volume, *ceteris paribus*, segmental EBIT grows 1.4%. On the other hand, for every 1% increase in gross selling price, *ceteris paribus*, the net price increases 2.2% and EBIT by 4%.

For every 1% increase in gross selling price, *ceteris paribus*, the net price increases 2.2% and EBIT by 4%

Figure 9: **Unique cost structure**

	% of gross price	% of net price
Gross price	100.0	218.3
Excise	54.2	118.3
Net price	45.8	100.0
Raw materials	8.6	18.7
Gross contribution	37.2	81.3
Other costs	12.5	27.3
EBIT	24.7	54.0

Source: Company data, Credit Suisse estimates

The imposition of VAT does not change the nature of the cost structure. VAT paid will, of course, depend on volume, price and mix of sales. However, it remains fixed as a percentage of gross sales and, thus, EBIT is just as sensitive to volume and price changes as before. Following the imposition of VAT, ITC has increased the selling price of most of its brands by an average of about 20.4% (weighted by its volume of sales in FY07). After accounting for 12.5% VAT on gross sales and a 5% increase in specific excise duties, we show that this effectively means an increase of 9.4% in net realisations for the company (Figure 10: Net realisation set to increase by around 9.4%), assuming that the mix stays as it was in FY07. This would be the highest increase in net realisation since FY02. On a per-unit basis, EBIT is likely to grow 16.5%, assuming a weighted average increase of 1.3% in raw material costs and 1% in other costs, including fixed costs.

Figure 10: **Net realisation set to increase by around 9.4%**

	FY07	FY08E	Change (%)
Net dealer invoice	100.00	120.40	20.4
VAT	0.00	13.38	
VAT (as % of gross sales)	0.0	12.5	
Gross sales	100.00	107.02	7.0
Excise	54.20	56.91	5.0
Net sales	45.80	50.12	9.4
Raw material	8.58	8.69	1.3
Gross profit	37.23	41.43	11.3
Other costs	12.51	12.63	1.0
EBIT	24.72	28.79	16.5

Source: Company data, Credit Suisse estimates

We forecast cigarette volumes to drop 6% in FY08E on account of an increase in prices. After accounting for all taxes and based on our calculation shown above, we expect gross sales to grow 0.6% (indexed to 100) and net sales to grow 2.9%. Under these assumptions, we expect EBIT from the cigarette business to grow 6.4% (compared to 17.1% in FY07 and 16% p.a. in FY04-07) and segmental margins to improve 150 bp in FY08E.

Figure 11: **EBIT margins set to expand 150 bp**

	FY07	FY08E	Change (%)
Volume (indexed to 1)	1.00	0.94	-6.0
Net dealer invoice (indexed to 100)	100.00	113.18	13.2
VAT paid	0.00	12.58	
VAT (% of gross sales)	0.0	12.5	
Gross sales	100.00	100.60	0.6
Excise	54.20	53.49	-1.3
Net sales	45.80	47.11	2.9
Raw material cost	8.58	8.17	-4.8
Gross profit	37.23	38.94	4.6
Other cost	12.51	12.63	1.0
EBIT	24.7	26.3	6.4
EBIT margins (% of gross sales)	24.7	26.2	+150 bp

Source: Company data, Credit Suisse estimates

EBIT will grow as long as volume decline is contained below 10% in FY08E

Our argument about the higher sensitivity of EBIT growth to price rather than to volume is reinforced by the sensitivity table below (Figure 12: EBIT sensitivity to price and volume). As can be seen, EBIT will grow as long as volume decline is contained below 10% in FY08E. The worst volume decline was seen in FY02, when it fell 8.4% after prices rose 14%. However, we note that the average price increase in FY98-02 was 12.8% p.a., much higher than the 6.6% p.a. price rise in the past five years (including the latest price increase).

Figure 12: **EBIT sensitivity to price and volume**

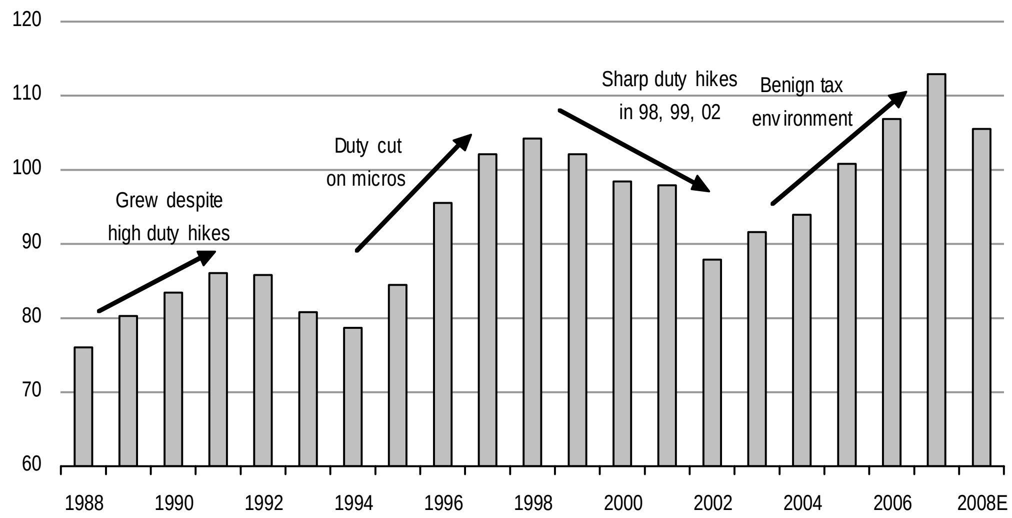
		Volume					
		-2%	**-4%**	**-6%**	**-8%**	**-10%**	**-12%**
Selling price	**14%**	-9.4	-12.3	-15.2	-18.1	-21.0	-23.9
	16%	-2.4	-5.4	-8.4	-11.5	-14.5	-17.5
	18%	4.7	1.5	-1.7	-4.9	-8.0	-11.2
	20%	11.7	8.4	5.1	1.8	-1.6	-4.9
	22%	18.8	15.3	11.8	8.4	4.9	1.4
	24%	25.8	22.2	18.6	15.0	11.4	7.8
	26%	32.9	29.1	25.4	21.6	17.9	14.1

Source: Company data, Credit Suisse estimates

Industry grows in line with PFCE

The cigarette industry has grown at 1.9% p.a. in volume terms in the past 15 years, with sharp cycles depending on various factors although the tax regime has been the biggest determinant. Growth in the past five years has been 5.3%, helped by a benign tax environment and an economy that has grown at its fastest in the period under study. Tax increases for FY08 have been sharp and we forecast a drop of 6.5% in volumes for the industry. Unlike in the past, however, we believe that the industry will resume growth from FY09, as other macro factors are very supportive of strong consumer demand.

Figure 13: Cigarette industry volumes have been cyclical

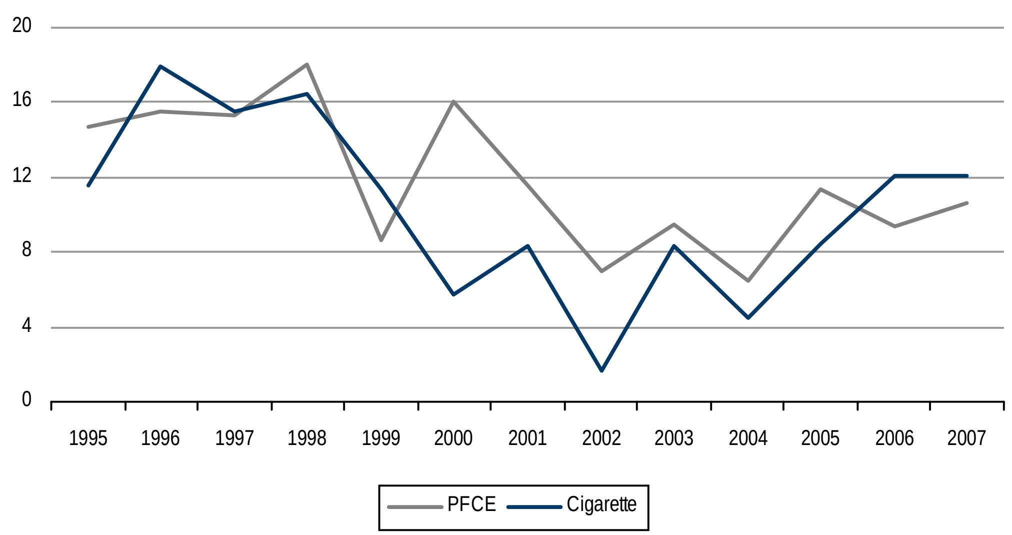


Source: Trade magazines, Government websites, Credit Suisse estimates

The growth in total consumer expenditure on cigarettes has moved in line with the total PFCE in nominal terms. In the future as well, we forecast the gross value of cigarette sales to increase in line with PFCE.

Total consumer expenditure on cigarettes has moved in line with the total PFCE in nominal terms

Figure 14: Consumer spend on cigarettes has moved in line with PFCE



Source: Government websites, company data, Credit Suisse estimates

Our assumptions factor in a 6.5% drop in volumes and an average price increase of 18% for the industry. This implicitly assumes total consumer expenditure on cigarettes to grow

10.2%, lower than the growth of 12.1% in FY07 and in FY06 (our economist forecasts PFCE growth in FY08E to be similar to that in FY07).

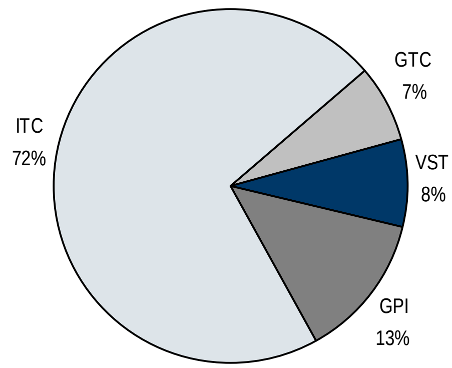
A bigger concern in the recent past has been the increasingly severe restrictions on smoking in public places and graphic health warnings on cigarette packs. We do not foresee any major drop in industry volumes as a result of these measures. What is of concern to us is that other tobacco products are not covered under these regulations.

Consolidated industry – ITC is likely to increase share further

ITC's volume growth has been almost twice that of the industry at 3.7% p.a. in the past 15 years. ITC's volume market share stands at 72.9%, up from 56.6% 15 years ago. In value terms, ITC's market share is a much higher 83.9%.

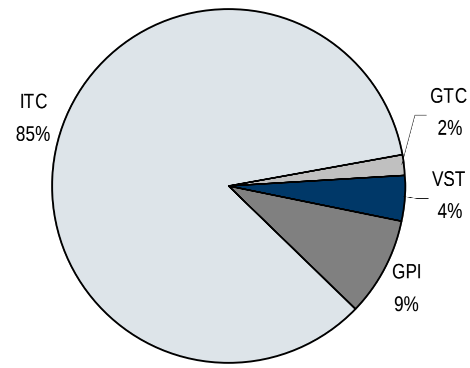
ITC's volume growth has been almost twice that of the industry at 3.7% p.a.

Figure 15: **Volume share**



Source: Company data, Credit Suisse estimates

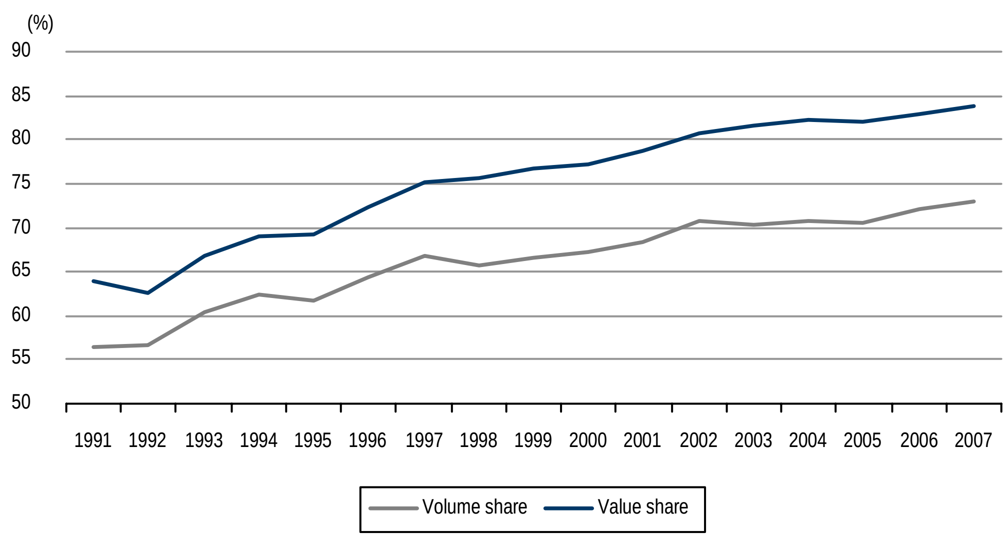
Figure 16: **Value share**



Source: Company data, Credit Suisse estimates

We expect ITC's market share to increase further in FY07-10E as well (from 72.9% in FY07 to 74.4% in FY10E in volume terms), as competition remains weak.

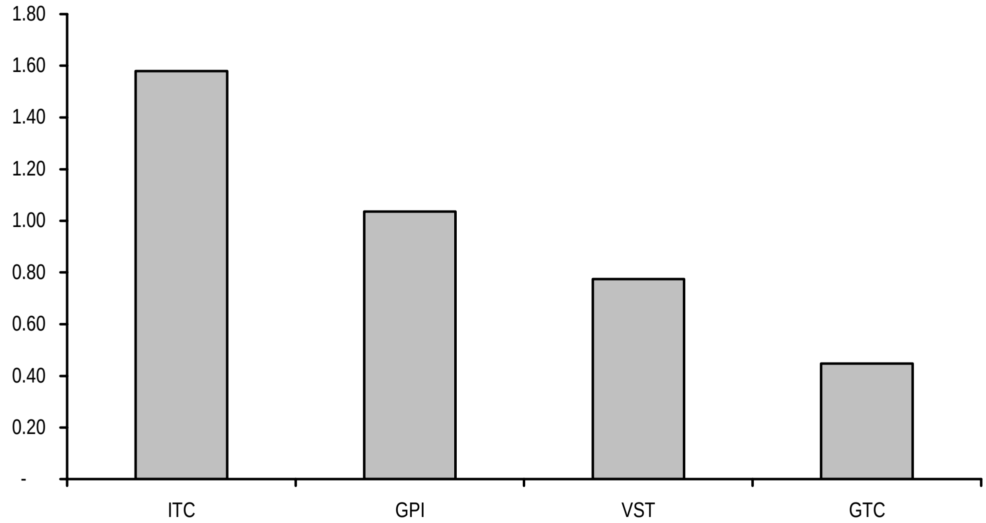
Figure 17: **ITC's market share has continuously increased**



Source: Company data, Credit Suisse estimates

Domestic competition stems primarily from three other players: Godfrey Phillips (GDFR.BO, Rs1,357.85, not rated), VST Industries (VSTI.BO, Rs368.15, not rated) and GTC Industries (GTC.BO, Rs235.5, not rated). While Godfrey Phillips is a strong player in middle-price segments, the others, VST and GTC, are predominantly at the lower end of the market. The difference in positioning is clearly borne out by the difference in gross realisations for these companies (see Figure 18:).

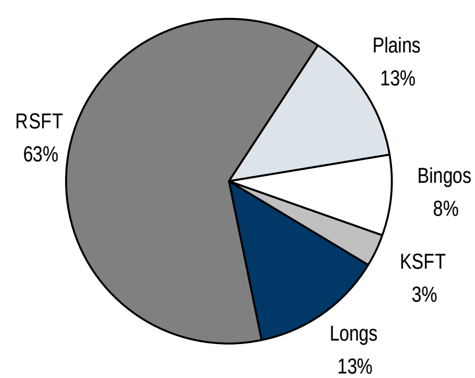
Figure 18: Gross price per stick – competition is at lower end



Source: Company data, Credit Suisse estimates

ITC dominates the top-end, brand-sensitive market (the regular size, long and king-size filter markets) which account for nearly 72% of ITC's sales by volume. These segments contribute to almost 82% of ITC's cigarette business EBIT.

Figure 19: ITC's cigarette sales distribution (by volume)



Source: Company data, Credit Suisse estimates

Incremental FDI in cigarettes is prohibited and, in our view, likely to stay that way for a while

Competition to ITC's top brands can incrementally come only if foreign brands are allowed into the country. That would require an easing of foreign direct investment norms for cigarettes. Incremental FDI in cigarettes is prohibited and in our view, likely to stay that way for a while. Even if FDI were allowed, foreign brands would face large challenges in distribution and brand awareness. The latter is a bigger problem, as media advertisements of cigarettes are banned in India (India is a signatory to the Framework Convention for Tobacco Control).

Figure 20: ITC cigarettes – P&L statement

	2005	2006	2007	2008E	2009E	2010E
Volume (mn)	69,998	75,894	81,265	76,389	81,736	86,641
Volume growth (%)	7.1	8.4	7.1	-6.0	7.0	6.0
VAT (% of gross sales)	0.0	0.0	0.0	12.5	12.5	12.5
Gross sales (Rs mn)	99,964	113,229	128,244	128,988	143,538	158,236
Excise (Rs mn)	56,091	62,431	69,504	68,600	77,073	85,782
Net sales (Rs mn)	43,873	50,798	58,740	60,388	66,465	72,454
Growth (%)	11.8	15.8	15.6	2.8	10.1	9.0
EBIT (Rs mn)	22,888	27,088	31,722	33,734	37,559	41,217
Growth (%)	12.6	18.3	17.1	6.3	11.3	9.7
Gross price/stick	1	4	6	7	4	4
Excise duty/stick	-1	3	4	5	5	5
Net price/stick	4	7	8	9	3	3
EBIT/stick	5	9	9	13	4	4

Source: Company data, Credit Suisse estimates

Other businesses progressing well

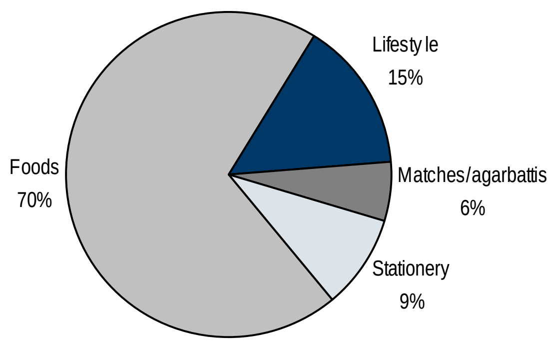
ITC has chosen to invest cash flows arising out of its cigarette business into long-gestation businesses, such as hotels and paper, rather than paying out high dividends. Businesses other than tobacco, which by nature earn a much lower return, account for 76% of capital employed. Despite this, ITC has successfully cross-leveraged strengths in various businesses to ensure its firm levels of ROE stay at a very healthy 25%.

FMCG: building up scale

ITC has built a Rs10.7 bn branded packaged foods business in less than four years

ITC is in the process of building new consumer (FMCG) businesses that leverage on its redoubtable distribution and procurement networks. Having started with foods, based on its natural sourcing advantage in agri-commodities, ITC is now looking to expand into new product categories. ITC is already the largest player in the domestic packaged wheat flour category (leveraging off the agri sourcing business), matches (leveraging on its cigarette distribution strength) and agarbatti (incense sticks) industries. It has also captured nearly a 10% market share in the domestic biscuit industry in a short span of four years. As a result, in less than four years, ITC has built a Rs10.7 bn branded packaged foods business.

Figure 21: Split of FMCG sales in FY07



Source: Company data, Credit Suisse estimates

So far, ITC's strategy in the foods business has been to: 1) use its established procurement network to source wheat and other agri inputs at a price lower than the competition, 2) have high quality control as a result of direct control over procurement, 3) ensure aggressive pricing and 3) make huge investments in brand promotion. We believe that the e-choupal (rural sourcing and distribution infrastructure) initiative provides ITC with significant cost savings over the competition.

In addition to biscuits (a 10% share) and branded atta (a 52% share), ITC recently entered the impulse snack market with the brand name 'Bingo' and a high-decibel media campaign to back it up. The packaged impulse snacks market is estimated to be over Rs40 bn in size and growing at nearly 30% p.a. Pepsico foods (PEP, $64.67, Not rated) is the largest player in this market with estimated sales of over Rs10 bn. ITC believes it can replicate its success in biscuits in the branded snacks market, as distribution and procurement strategies are similar for both categories.

In addition to its existing products, ITC has plans to enter other FMCG products, from soaps to beauty products. While ITC might launch soaps and personal products in FY08E itself, entry into other categories is likely to occur in FY09E and beyond. ITC has the distribution strength, negotiating leverage with trade channels and the balance sheet strength in these categories. However, unlike in the past, ITC will be up against much larger competitors and is likely to lack the brands that the incumbents have. Thus, ramp-up in these businesses is likely to be much slower than in its existing portfolio.

ITC has plans to enter other FMCG products, from soap to beauty products, in FY08E

Figure 22: Possible new FMCG businesses

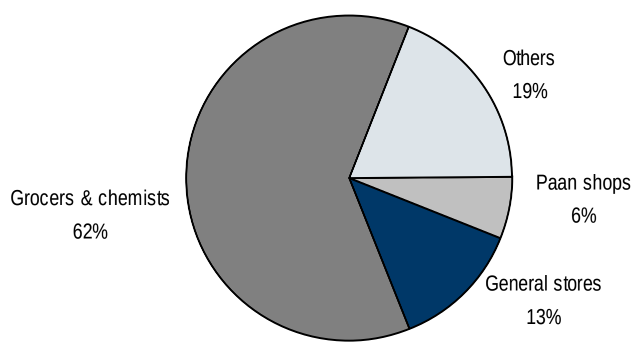
Category	Market size (Rs mn)	ITC's presence
Biscuits	50,000	10% share, growing
Branded snacks	40,000	Just launched
Match sticks	12,000	Nearly 10% share
Branded atta	12,000	50% share
Soaps	60,000	Likely launch in FY08E
Shampoo	20,000	Likely launch in FY08E
Detergent	70,000	Likely in FY10E
Oral care	30,000	Likely in FY10E

Source: Company data, Credit Suisse estimates

Distribution is a key strength of ITC's. ITC's products reach over 1 mn outlets. However, while much of the distribution network is common (between cigarettes and other FMCG), ITC's cigarette distribution does not supply to a large number of retail outlets, such as chemists and grocers. ITC's distributors have been investing in a separate sales force for these retail outlets in the past four years, but ITC does not have a competitive advantage over its competition in this. This could be another impediment to a speedy ramp-up of its new businesses.

Distribution is a key strength of ITC's

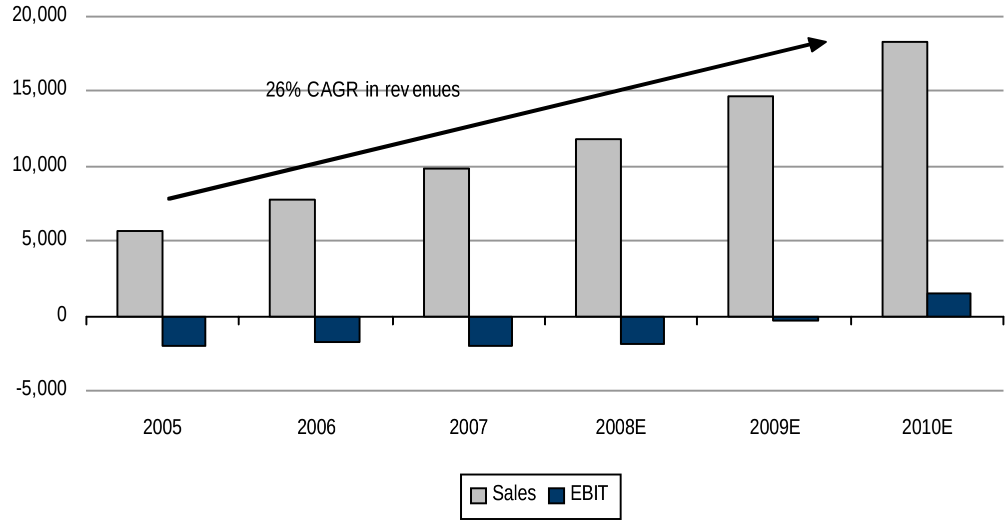
Figure 23: Channel-wise distribution of FMCG sales in India



Source: Industry, Credit Suisse estimates

ITC's growth in the FMCG business has come with huge investments. For example, ITC has reinvested its entire savings from a ban on cigarette advertising (estimated at about Rs1 bn p.a.) into the FMCG business. For the moment, ITC is concentrating on building scale and we think break even in existing businesses is likely to be achieved by early FY09. However, entry into new businesses is expected to delay segmental profitability, which we forecast only in FY10E.

Figure 24: **FMCG: Strong growth in sales but profitability only in FY10E**



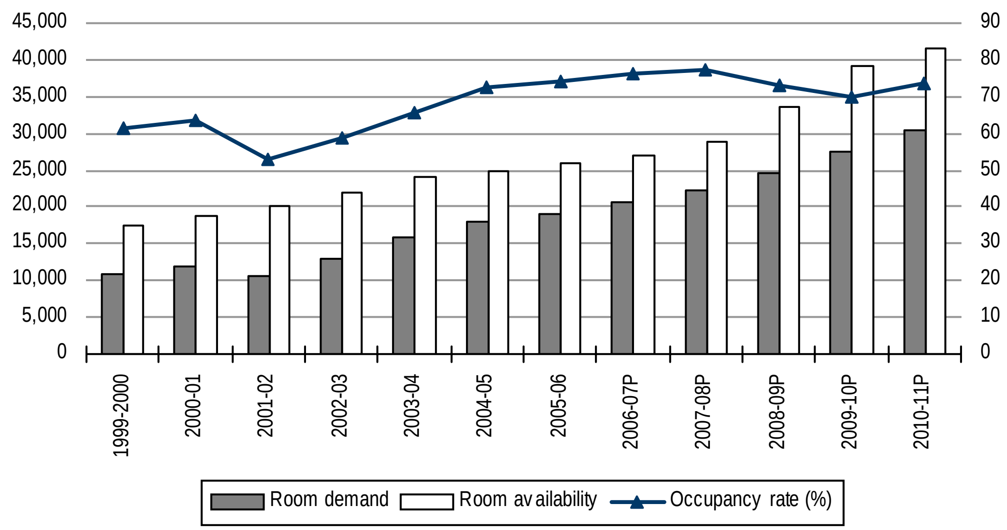
Source: Company data, Credit Suisse estimates

Hotels: in a sweet spot

The hotel business has seen strong growth in profitability in the past few years, as the occupancy and rentals witnessed sharp increases across all the major cities in India. The rapid growth in tourist arrivals and booming economy continue to support increasing profitability. The supply-demand scenario in the hotel industry is likely to remain benign for the next few years, supporting high occupancy and rentals.

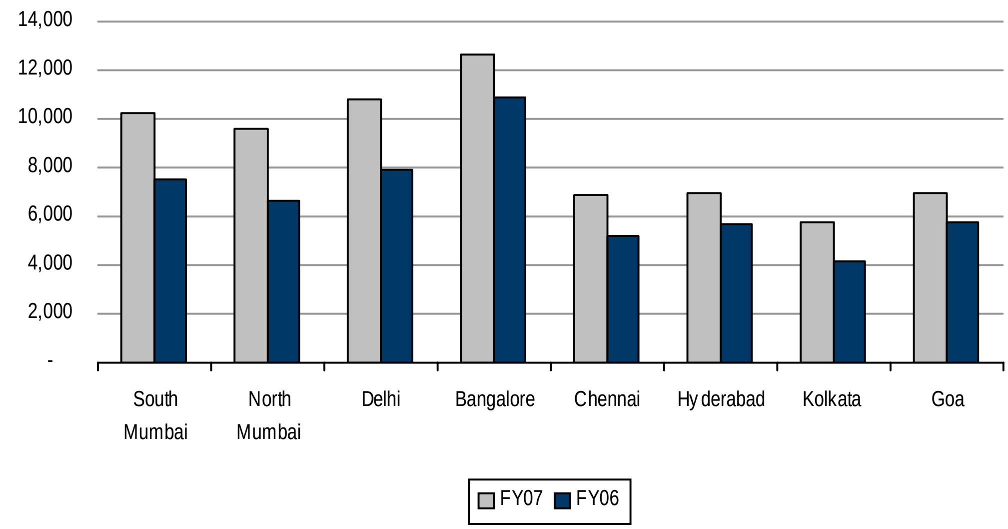
The supply-demand scenario in the hotel industry is likely to remain benign for the next few years

Figure 25: **The supply-demand scenario is likely to remain benign**



Source: CRIS-Infac, Credit Suisse estimates

Figure 26: **Room rentals have increased 16-44% in major cities**



Source: Indian Hotels

ITC plans to add three new properties over the next three to four years (one each in Bangalore, Hyderabad and Chennai). Work on the Bangalore hotel has commenced and is expected to be completed in 18-24 months. We expect ITC to grow its hotel revenues by 12% p.a. in FY05-08E and EBIT by 26% in the same period. However, FY08E is likely to be the peak in terms of growth and profitability as increasing occupancy from the current properties might be increasingly difficult. Moreover, ITC's new properties, slated to start from FY09E onwards (a 300-room hotel in Bangalore in FY09E and a 800-room hotel in Chennai in FY10E) is likely to drag down profitability as it takes time to scale up.

ITC plans to add three new properties over the next four to five years

Figure 27: **Strong EBIT growth is likely to be sustained**

	FY07	FY08E	FY09E	FY10E
Rooms	4,900	5,100	5,500	6,300
Occupancy (%)	70	73	76	72
RevPAR (Rs)	7,873	8,643	9,622	11,084
Growth (%)	18	10	11	15
Revenue (Rs mn)	9,857	11,744	14,680	18,351
Growth (%)	26	19	25	25
EBIT (Rs mn)	3,508	4,209	5,262	6,577
Growth (%)	36	20	25	25
EBIT margin (%)	36	36	36	36

Source: Company data, Credit Suisse estimates

Paper: capacity addition in FY09E

ITC's paper business has natural synergies with the other businesses. ITC requires a huge amount of packaging material for its FMCG businesses. More than one-third of its paper production is used for internal consumption.

More than one-third of its paper production is used for internal consumption

The paper industry is capital intensive and prone to global cycles. The capital intensity of the business is bound to increase as environmental norms tighten. However, ITC is one of the few large paper manufacturers that can support aggressive investments in the fast growing Indian paper market (7% p.a. versus the world average of 2%). Most Indian paper mills are small (98% of mills have a capacity of <50,000 tpa versus the ideal of 300,000 tpa) and therefore the industry is fragmented (large mills account for only 33% of output). A new integrated greenfield plant of 300,000 tpa requires an investment of Rs4.5-5 bn, an amount that very few paper companies in India can afford. Thus, ITC is well positioned to lead consolidation in the industry.

ITC is currently expanding capacities across segments. It is in the process of doubling pulp capacity (to 200,000 tpa) which should come on stream in 2H FY08E. This would help ITC reduce dependence on the global pulp cycle and cut costly imports. ITC's paper board business is also facing capacity constraints and a new 90,000 tpa capacity is scheduled to come on stream by end of FY09E. Finally, a new paper mill (capacity of 100,000 tpa) is also being put up by the end of FY09E.

Figure 28: **Capacity addition in pulp in FY08E, in papers in FY09E**

(tpa)	FY07	FY08E	FY09E
Coated and uncoated boards	320,000	320,000	400,000
Paper	30,000	30,000	30,000
Specialty paper	24,000	24,000	125,000
Total paper	54,000	54,000	155,000
Pulp	100,000	200,000	200,000

Source: Company data, Credit Suisse estimates

ITC is exploring opportunities to invest in new greenfield plants

ITC is exploring opportunities to invest in new greenfield plants, with an emphasis on self sufficiency in raw materials. Raw materials and power cost account for over 65% of the total cost for any mill and thus sourcing of raw materials can be critical in determining the profitability. Currently, ITC imports waste paper and soft wood, and sources hard wood from its own plantations or from other domestic sources. On the energy front, all except one of the units are self sufficient. Work on the new green plant is likely start in FY09E and ITC is likely invest about Rs25 bn in this project.

We expect the paper business to witness a 10.3% CAGR in EBIT in FY07-10E

We expect volume growth to be muted in FY08, due to a lack of capacity. Volume growth should pick up from FY09 once the new paper board and paper capacities come on stream. Margins are likely to be boosted from better mix changes and higher in-house pulp manufacture in FY08E. We expect the paper business to witness a 10.3% CAGR in EBIT in FY07-10E on volume growth of 12.7% p.a.

Figure 29: **Paper business – P&L**

	2005	2006	2007	2008E	2009E	2010E
Specialty paper (tonnes)	20,000	19,871	19,674	20,658	22,723	24,996
% growth	16.2	-0.6	-1.0	5.0	10.0	10.0
Paper boards & paper (tonnes)	236,920	290,109	301,196	316,256	395,320	434,852
% growth	39.7	22.5	3.8	5.0	25.0	10.0
Segmental revenue (external)	15,653	18,957	21,001	22,669	26,772	29,695
External sales	9,912	11,503	12,716	13,557	16,748	18,668
Segmental PBIT	2,800	3,514	4,168	4,499	5,048	5,599
PBIT margins (%)	17.9	18.5	19.8	19.8	18.9	18.9

Source: Company data, Credit Suisse estimates

Agri business and e-choupal

ITC is likely to procure about Rs38 bn worth of agricultural commodities in FY08E

ITC is India's second-largest exporter of agricultural commodities and has a significant presence in soya, wheat, rice and marine products. The company is likely to procure about Rs38 bn worth of agricultural commodities in FY08E, used for exports, domestic trading and in-house consumption (split roughly equally). The procurement of certain commodities like soya and wheat has almost entirely moved into the choupal network. As ITC deals directly with farmers, it is also in a position to influence the variety and strain of the produce, gradually educating and giving incentives to farmers to move to profitable ones.

Gradually, ITC plans to expand the portfolio of products being sourced. Currently, ITC sources 13 commodities (11 bulk dry commodities, coffee and aquaculture). While scaling up the existing business, ITC plans to enter the horticulture market as well, focusing on a portfolio of 20 vegetables and 10 fruits.

This growth in agricultural sourcing should help not only the trading business but also in building cost advantages for the processed foods business. For example, ITC could procure almost 10% of India's total soya production (15% in the state it operates in, which in turn accounts for over 60% of India's production), thereby giving ITC considerable clout with the trade.

Sourcing advantage

ITC has built on its sourcing scale to establish an enabling infrastructure, called e-choupal. ITC's choupal network gives the company tremendous control over quality and cost of the commodities being bought. Since ITC buys directly from the farmers, it is in a position to track the source of the produce and manage future procurement accordingly. The resultant quality control is likely to enable ITC to have a better control over allocation of the commodity to trade and internal consumption. The traceability should also allow ITC to address food safety concerns and once again provide a value that the customer is willing to pay for. This would, in turn, lead to better realisations for the farmers as well, as ITC would then command a traceability premium. For example, ITC uses different varieties of wheat for sale in southern and northern India and has control over the source of the wheat.

The direct savings, due to procurement from the choupal network, are about 5%, in our view. The savings are shared between the farmer and the company, which in turn uses the savings to fund the infrastructure investments. The employees who run the network are given incentives through the commission that the network earns on the procurement. The farmer is likely to find it easier to justify switching from the traditional mandis (wholesale market) to choupal as their effective realisation (per tonne) increases significantly and is also paid instantaneously (the resultant cash disbursement cost is borne by the company).

The direct savings, due to procurement from the choupal network, are about 5%

We note that the savings from the elimination of unscrupulous practices (like tampered meters) are likely to be competed away over time, as the mandis install electronic meters (as they have already done in many states). However, the benefits will still be substantial for the farmer to switch to ITC choupal.

The savings on disintermediation are likely to be far higher in the case of horticulture. The intermediation cost on perishable horticulture is estimated to be over 200%, compared to 10-15% in the case of dry bulk agriculture commodities.

Having built an infrastructure that is funded by savings on sourcing, ITC is now using the same network to increase rural retailing. The choupal network doubles up as a super store and sells wide-ranging products, from FMCG to electronics goods and agricultural inputs to financial products. The network has assured footfalls in the form of farmers who come to sell their produce. Over 40 companies have started selling their products through the network, getting access to new consumers in a more cost effective manner. The goods are retailed at a discount to market, very similar to the model of modern retailing. And unlike modern retailers in urban centres, the cost of real estate is insignificant

ITC already has 6,400 choupals and 18 hubs under operation and plans to increase the number of hubs to 30 by the end of FY08E. ITC's sourcing through the choupal network touched nearly 1 mn tonnes in FY07 (about 45% of total agri commodity purchases) and retail sales through the network were over Rs1.7 bn.

ITC already has 6,400 choupals and 18 hubs under operation

Figure 30: **Great scale in agri sourcing business**

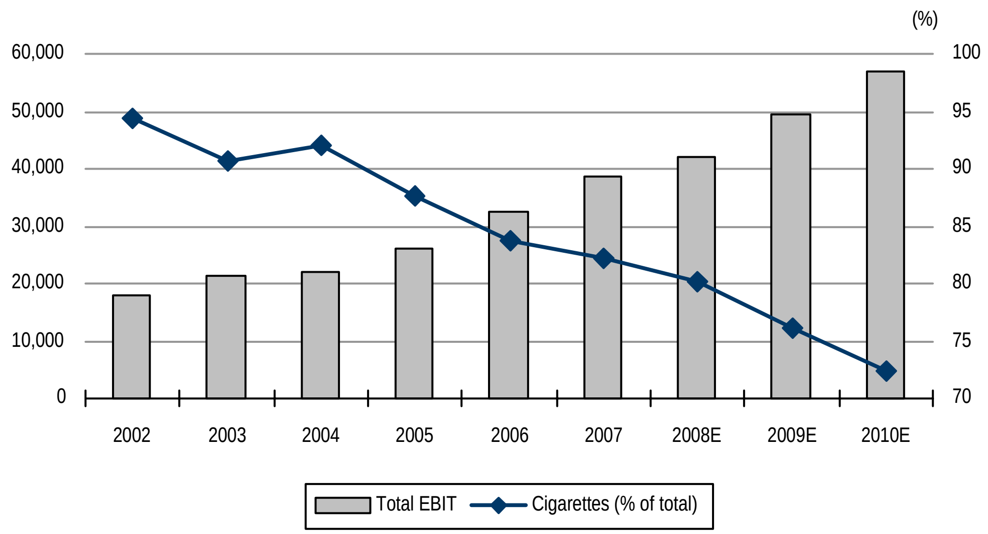
	2005	2006	2007	2008E	2009E	2010E
Agri-products sold (tonnes)	535,663	1,081,913	1,324,636	1,589,563	1,907,476	2,193,597
% growth	-2.9	102.0	22.4	20.0	20.0	15.0
Agri-commodity sourcing (tonnes)	855,461	1,826,291	2,236,757	2,767,155	3,349,652	3,924,765
% growth	-19.0	113.5	22.5	23.7	21.1	17.2
Segmental revenue (total)	17,801	26,784	36,914	43,543	52,243	61,222
External sales	12,207	19,547	27,196	31,396	37,058	42,242
Segmental PBIT	964	909	1,236	1,457	1,749	2,049
PBIT margins (%)	5.4	3.4	3.3	3.3	3.3	3.3

Source: Company data, Credit Suisse estimates

Financials

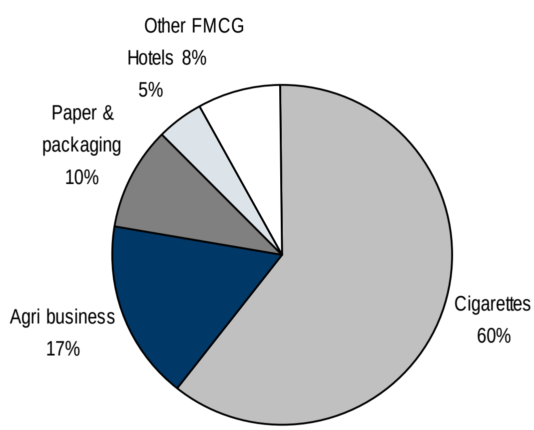
ITC has been aggressively investing in new businesses and ventures in the past few years. While the capital allocation has undergone a sea change, the profit mix is still dominated by the cigarette business. While we expect the share of the cigarette business to drop gradually, we believe that it will be a while before the other businesses start contributing meaningfully to cash flows, as many of these businesses are still in investment mode.

Figure 31: Cigarettes contribution to EBIT



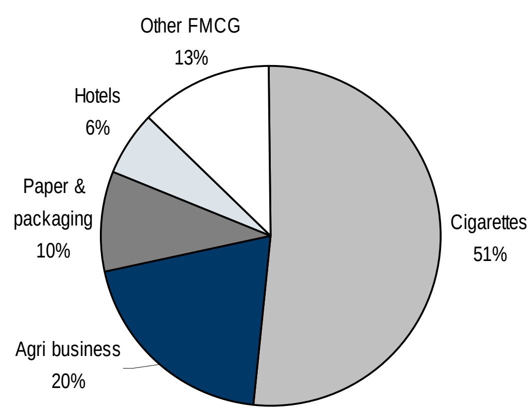
Source: Company data, Credit Suisse estimates

Figure 32: Sales mix in FY07 …



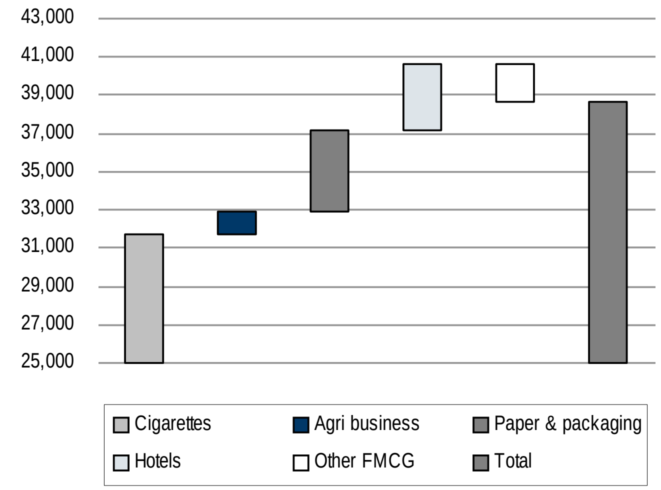
Source: Company data, Credit Suisse estimates

Figure 33: … and in FY10E



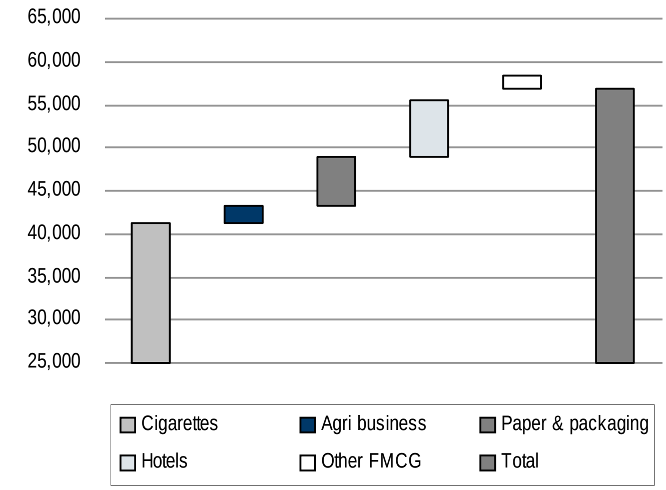
Source: Company data, Credit Suisse estimates

Figure 34: **EBIT build-up in FY07 …**



Source: Company data, Credit Suisse estimates

Figure 35: **… and in FY10E**



Source: Company data, Credit Suisse estimates

Figure 36: **Segmental revenue and profitability**

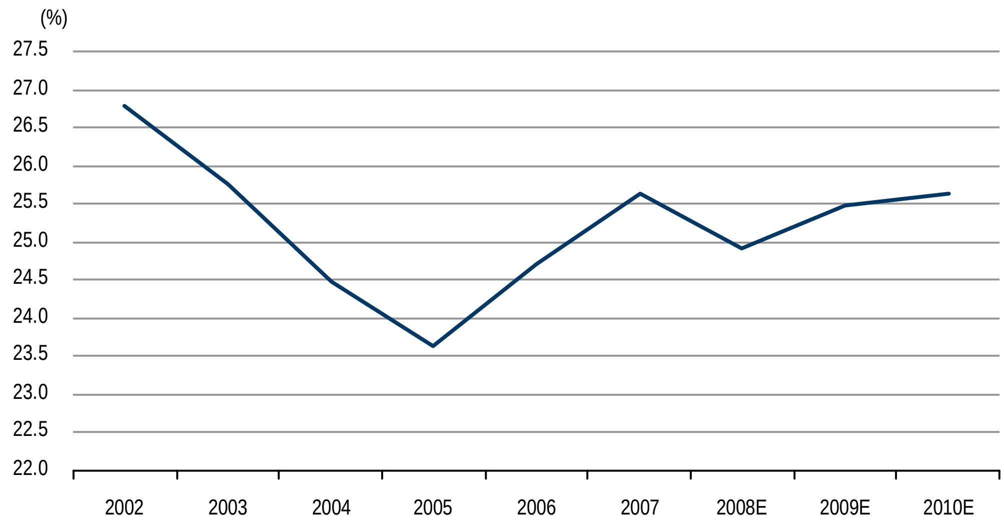
(Rs mn)	FY05	FY06	FY07	FY08E	FY09E	FY10E
Segmental revenue (total)	144,886	177,007	213,152	232,140	268,819	307,146
Segmental revenue (external)	133,496	162,244	195,051	210,880	243,610	277,139
Cigarettes	100,025	113,297	128,337	128,988	143,538	158,236
Agri business	17,801	26,784	36,914	43,543	52,243	61,222
Paper & packaging	15,653	18,957	21,001	22,669	26,772	29,695
Hotels	5,773	7,834	9,857	11,744	14,680	18,351
Other FMCG	5,634	10,135	17,044	25,195	31,585	39,642
Less: inter-segment revenue	-11,390	-14,763	-18,101	-21,260	-25,208	-30,007
Segmental PBIT						
Total	26,110	32,373	38,613	42,074	49,327	56,930
Cigarettes	22,888	27,088	31,722	33,734	37,559	41,217
Agri business	964	909	1,236	1,457	1,749	2,049
Paper & packaging	2,800	3,514	4,168	4,499	5,048	5,599
Hotels	1,409	2,581	3,508	4,209	5,262	6,577
Other FMCG	-1,952	-1,718	-2,020	-1,826	-290	1,488
Segmental PBIT margins (%)						
Total	19.6	20.0	19.8	20.0	20.2	20.5
Cigarettes	22.9	23.9	24.7	26.2	26.2	26.0
Agri business	5.4	3.4	3.3	3.3	3.3	3.3
Paper & packaging	17.9	18.5	19.8	19.8	18.9	18.9
Hotels	24.4	32.9	35.6	35.8	35.8	35.8
Other FMCG	-34.7	-17.0	-11.9	-7.2	-0.9	3.8

Source: Company data, Credit Suisse estimates

ITC plans to step up capital expenditure from Rs2.9 bn p.a. in the past three years to about Rs12 b p.a. in the next three years. The capital expenditure is likely to be split equally among the various businesses (30% each for hotels, paper, FMCG including cigarettes). Despite higher capital allocation to other businesses, we expect ITC to maintain firm levels of ROE at about 25% over the next few years. ROEs in the paper and hotel businesses are set to improve further, as asset utilisation improves. Profitability in the existing non-tobacco FMCG business is also likely improve drastically, as the business scales up.

ITC plans to step up capital expenditure from Rs2.9 bn p.a. in the past three years to about Rs12 bn p.a. in the next three years

Figure 37: High and stable ROEs

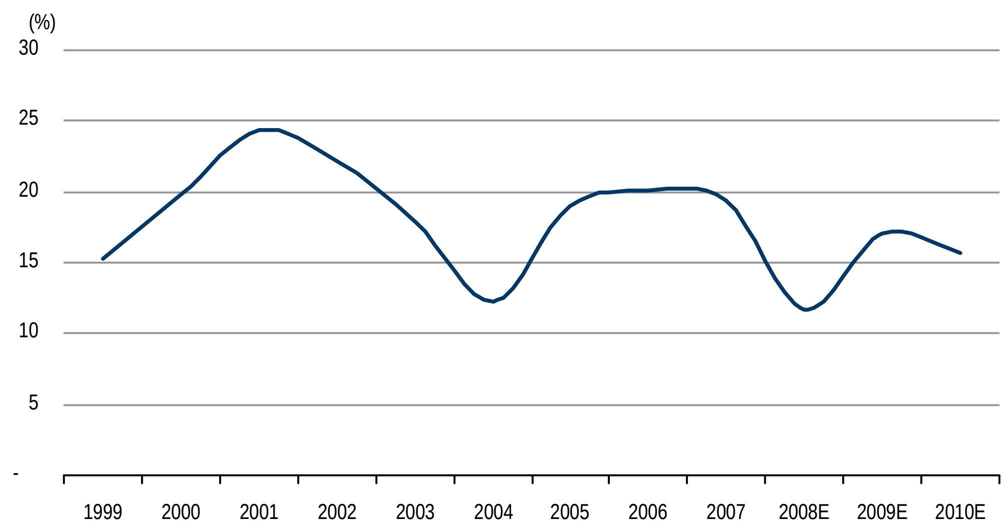


Source: Company data, Credit Suisse estimates

ITC's earnings growth has been very steady in the past, despite entry into long gestation projects and occasional headwinds affecting the cigarette business (due to tax increases). In fact, the earnings growth has ranged from 13-34% over the past ten years. In fact, stability of earnings is probably the most positive factor of ITC's performance.

We expect EBITDA to grow 14.2% p.a. and earnings to grow 15% p.a. in FY07-10E

Figure 38: Stable earnings growth



Source: Company data, Credit Suisse estimates

Valuations

Not factoring in execution capabilities

ITC's net profits have grown 21% p.a. in the past ten years and for any three-year period in the interim, its net profit has grown at least 16.5% p.a. (despite entry into long-gestation projects and various unfavourable tax measures). The recent underperformance leads us to believe that the market is underestimating management's capability to deliver strong results in times of adverse regulatory actions. We expect EBITDA to grow 14.2% p.a. and earnings to grow 15% p.a. in FY07-10E.

ITC's net profits have grown 21% p.a. in the past ten years

We value ITC on an SOTP basis and set a target price of Rs188, valuing the cigarette business at Rs110 (16.5x FY09E, in line with the average multiple of global peers). We believe that the market is excessively focused on short-term volume growth, or the lack of it, in cigarettes and will be positively surprised by segmental profit growth. At our target price, ITC would trade at 20.2x FY09E, in line with its long-term average, although the market multiples have moved significantly up. ITC trades at its lowest historical premium to the broader market, though the stable characteristics of its earnings profile remain intact. We have assigned it an OUTPERFORM rating.

Trading at its lowest premium to the market multiple

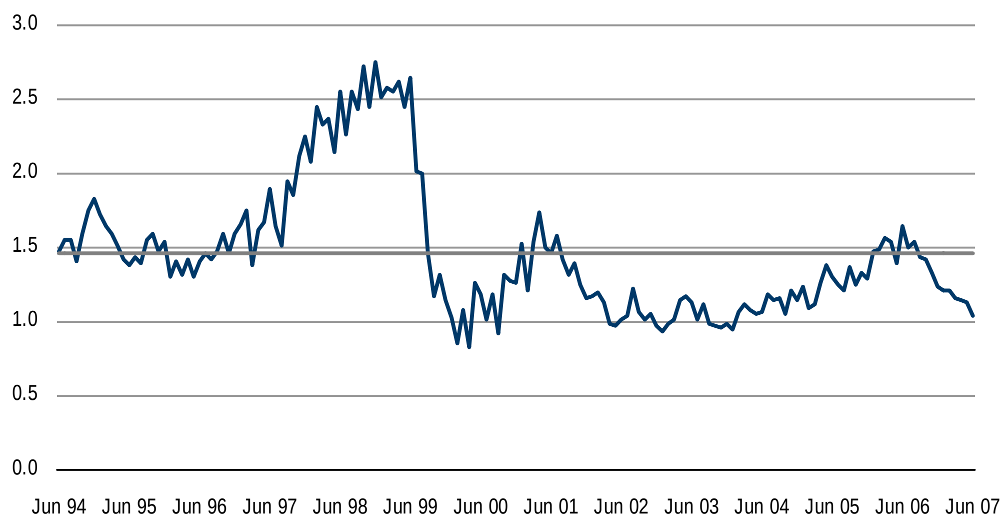
ITC has traditionally traded at a 50% premium to the market (MSCI India) P/E multiple. We believe the key reasons for this are:

ITC has traditionally traded at a 50% premium to the market (MSCI India)

- Predictable earnings growth (21% p.a. in the past ten years) with very little volatility (Figure 38: Stable earnings growth)
- Stable and higher-than-market ROEs (25.5% in FY07)
- Strong cash flows over the years

The premium has shrunk to 10% currently. All the above factors remain as relevant today as they were in the past. We forecast that ITC's earnings will grow 12.2% in FY08, but resume higher growth rates (16% p.a.) in FY08-10.

Figure 39: **Relative to market multiple**



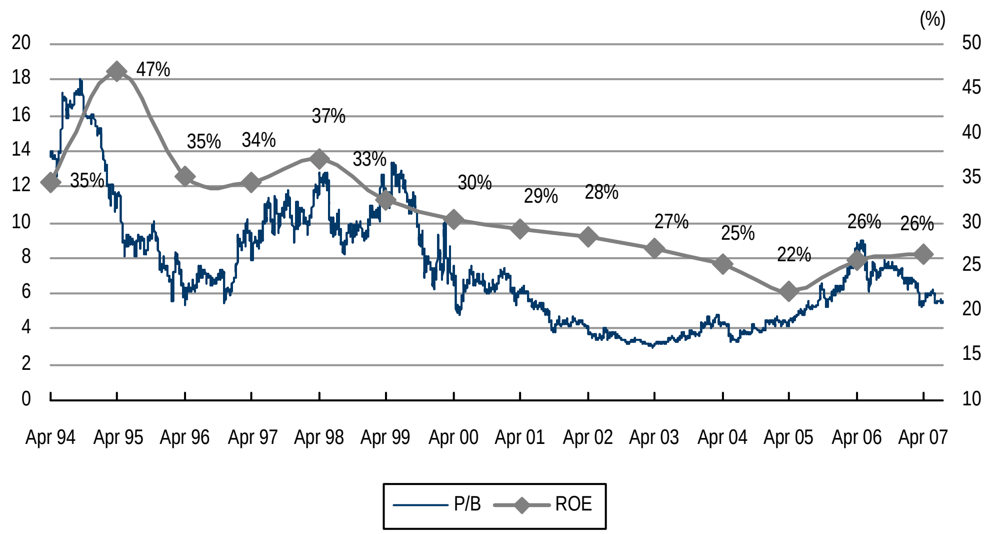
Source: MSCI, company data, Credit Suisse estimates

ROE to be sustained, so should P/B

A key concern for the market has been that ITC's investments in other capital-intensive businesses could pull down its ROE. As we argued earlier, despite increasing investment in other businesses, ITC has managed to maintain ROE at near 25%, and we expect it to sustain this in the future as well (Figure 37: High and stable ROE). ITC's P/B value has moved in line with ROE. While we do not expect the P/B to trend to its historical average (11x), we do believe that the current P/B of 5.6x is sustainable, given that ROEs will be sustained. At our target price, ITC would trade at 5.9x FY08E book value.

We believe that the current P/B of 5.6x is sustainable, given that ROEs will be sustained

Figure 40: P/B (LHS) to ROE (RHS)

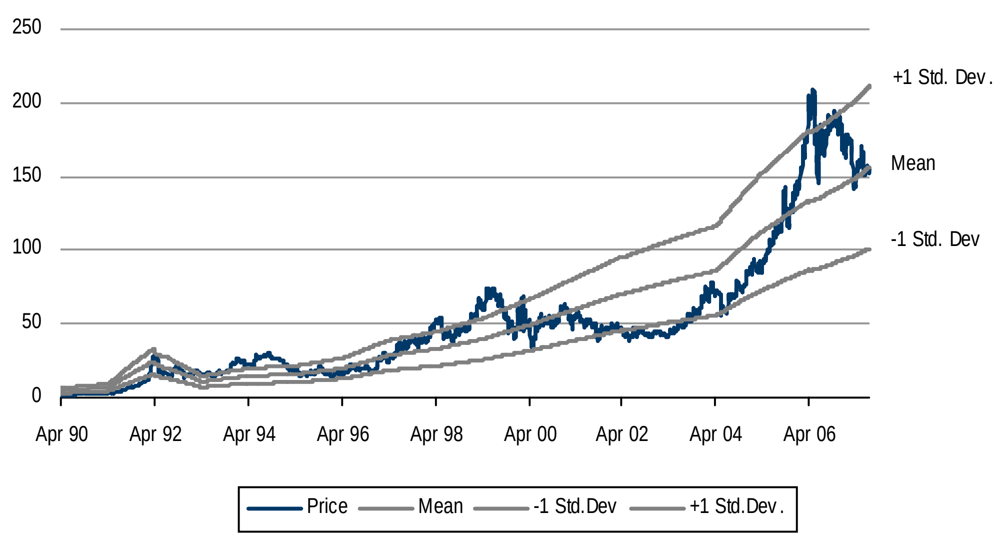


Source: Bloomberg, company data, Credit Suisse estimates

Trading at historical average forward P/E multiple

On a forward P/E basis (19.3x FY08E, 18.7x 12-month forward earnings), ITC is trading at its historical forward P/E average of 18.7x. In the long term, we expect the stock to deliver returns in line with its future earnings growth.

Figure 41: Historical P/E



Source: Bloomberg, company data, Credit Suisse estimates

SOTP valuation

We prefer valuing ITC on a sum-of-the-parts basis. Given the disparate nature of its businesses and the different earnings drivers in each of these, SOTP is the best way to value ITC, in our view. SOTP has the obvious shortfall of not capturing synergies among various businesses. However, that is factored into our earnings forecast. Our SOTP value of Rs188 implies 22% potential upside from the CMP. As a result, we assign the stock an OUTPERFORM rating.

Cigarettes: Rs110/share based on P/E global comparatives

We prefer valuing the cigarette business on a P/E basis, as the business has steady, predictable and growing earnings across the region. We use a global average multiple of 16.5x FY09E earnings to value the cigarette business at Rs110 per share.

As can be seen in the table below, despite a short-term tax-induced slowdown in earnings growth, it still has among the best earnings growth profiles of global tobacco companies. The profitability of the business is also among the best, with ROE as high as 105% in the cigarette business. With above-average growth and ROEs, one could justify a premium for ITC given the lower litigation risk and higher growth prospects in India than in the other markets. However, in the short term, concerns over volume growth are likely to overshadow long-term growth prospects.

We use global average multiple of 16.5x FY09E earnings to value the cigarette business at Rs110 per share

Figure 42: **Global tobacco comparatives**

	EPS growth (%)	ROE (%)	Dividend payout (%)	P/E (x)	EV/EBITDA (x)	Dividend yield (%)	Premium to MSCI [2]
Altria Group, Inc.	9.4	32	58	16.7	10.4	4.3	1.1
British American Tobacco	8.4	29	60	15.4	9.9	4.0	1.2
Gudang Garam	22.3	8	0	15.9	8.7	4.4	1.2
Japan Tobacco	6.1	8	29	25.6	11.9	0.7	1.4
Reynolds American Inc.	6.0	18	71	14.9	8.2	4.6	1.0
Swedish Match	-0.2	63	0	18.1	12.6	2.1	1.3
UST Inc.	4.3	718	73	15.7	11.5	4.5	1.0
BAT Malaysia	7.3	123	101	15.0	10.4	6.5	0.9
Carolina Group	9.4	66	40	16.3	9.4	2.3	1.0
KT&G	12.1	20	49	14.6	10.2	3.8	1.2
Average				17.1	10.1		1.1
ITC (at target price) [1]	9.1	105	51	16.5	10.7	1.8	1.1

[1] ITC numbers except dividend payout and premium to MSCI are for its cigarette business

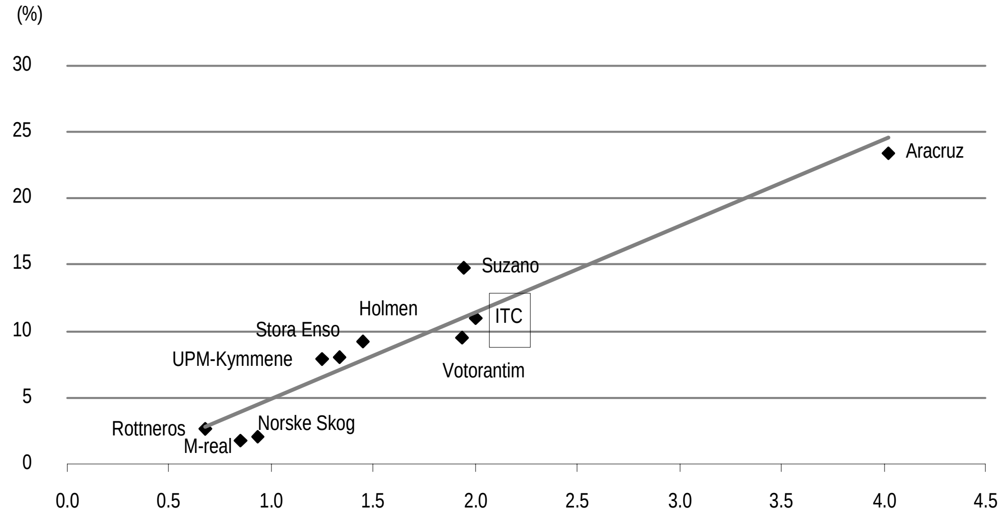
[2] MSCI relates to respective country indices

Source: Company data, Credit Suisse estimates

Paper: Rs15/share based on P/B to ROE

Paper is an asset-intensive global commodity. While paperboard (a predominant portion of ITC's sales) is relatively more insulated from global cycles, due to high freight cost involved, it is nonetheless impacted by global trends. Thus, we prefer valuing the business on P/BV to ROE, relative to its global peers. We value the papers business at Rs15 per share based on 2x P/FY08E BV. At this valuation, the paper business would trade at 16.9x FY09E, at a discount to the global average of 17.7x FY09E.

Figure 43: Global P/B to ROE comparison for paper



Source: Company data, Credit Suisse estimates

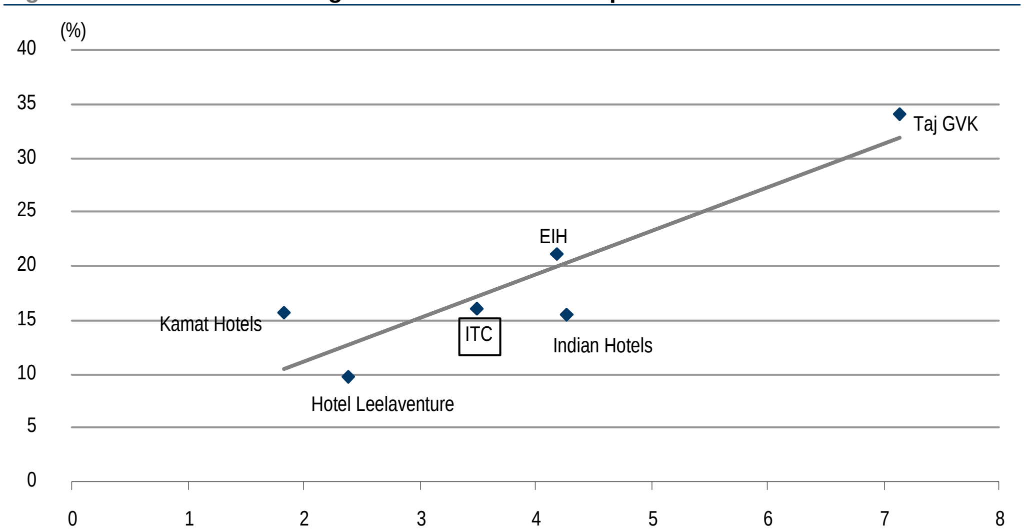
Hotels: Rs21/share based on P/B to ROE

ITC's hotel business has seen a huge improvement in profitability as growth came through increasing occupancy and rentals. However, the potential for high occupancy from the current levels is limited, and thus volume growth will require new investment. Nevertheless, given the huge growth in tourism, ITC could see further improvements in profitability on account of increasing average room rentals, at least in the near-to-medium term. We forecast that EBIT margins will peak at 36% in FY08E as ITC adds capacity in new properties from then on.

ITC's existing properties' replacement cost works out to around Rs20/share

We again use P/B for the hotel business, as it is asset intensive and has a long gestation period. Indian Hotels (IHTL.BO, Rs142.75 not rated) trades at a P/B of 4.3x (an ROE of 15.5% in FY07). We assign a P/B multiple of 3.5x FY08E (an ROE of 16%) for the hotels business and value it at Rs21 per share of ITC. At this valuation, the hotels business would trade at 22x FY09E forecast earnings. Based on current capex costs (Rs15 mn/room), ITC's existing properties' replacement cost works out to around Rs20/share.

Figure 44: P/B vs ROE among listed Indian hotel companies



Source: Bloomberg, company data, Credit Suisse estimates

FMCG: Rs25 at 3x P/sales

ITC's FMCG business excluding cigarettes is still in aggressive investment mode and is unlikely to report profits until FY09E. Consequently, we use the sector average price/sales multiple of 3x to set a target valuation of Rs25 per share for this business. We would like to note that this assigns an extremely high P/E multiple for the franchise.

We value the agri-commodity business at Rs3 per share, based on 10x FY09E earnings, given the low ROE of the business. We note that this does not factor in the sourcing and scale advantage that the choupal network brings to the business.

Figure 45: **SOTP-based target price of Rs182**

Cigarettes	
P/E (x)	16.5
Industry average P/E (X)	16.5
PAT FY09 E (Rs mn)	25,165
Price per share (Rs)	110
Paper	
P/B (x)	2
BV FY08E (Rs mn)	28,609
Price per share (Rs)	**15**
Implied P/ FY09E	16.9
Hotels	
P/B (x)	2.5
BV FY08E (Rs mn)	22,531
Price per share (Rs)	**21**
Implied P/FY09E	22.4
Agri business	
P/E (x)	10.0
PAT FY09E (Rs mn)	1,163
Price per share (Rs)	**3**
FMCG	
P/S (x)	3
Sales FY09E (Rs mn)	31,585
Price per share	**25**
Cash per share (FY08E)	**13**
Target price (Rs)	**188**

Source: Company data, Credit Suisse estimates

Key risks

Further excise duty increase in next year's Budget

The government has increased excise duty by 5% and allowed the imposition of VAT by states. A further sharp increase in excise duty next year would delay the recovery in volumes that we have forecast next year. In our forecasts, we have assumed a 5% increase in specific excise duties in FY09E and FY10E. The risks are weighted in favour of a lower hike in duties than what we have forecast.

FDI in tobacco

Competition to ITC in the domestic market is very limited. However, if the government were to allow easier entry of foreign brands through the relaxation of FDI norms, ITC would have to contend with new players with deep pockets and a great portfolio of products. However, we assign a very low probability to the relaxation of FDI norms. Not only would it be politically difficult to justify, but it would also be seen in a negative context by the powerful anti-tobacco lobby.

Restrictive regime on smoking

The union health ministry has stepped up its campaign against smoking in the recent past. Regulations have been passed against smoking in public places. Graphic warning signs on cigarette packs will soon be mandatory. The result of these measures in other countries is mixed. We have not factored in any negative impact on volumes due to these measures.

Downturn in other cyclical businesses

We have forecast strong growth in the paper industry and a benign supply-demand scenario for the hotel industry. However, both these are inherently cyclical in nature and could face a downturn if the economy were to slow down. In that scenario, earnings growth could slow substantially, and ROEs would also take a hit.

Execution risks in new ventures

ITC is investing heavily in new businesses. The company has a long and established track record in the cigarette business. Execution capability in new businesses has been above expectations in the past five years. However, new business initiatives, like e-choupal, are prone to both execution and political risks.

Appendix: Financials

Figure 46: **P&L statement**

Year-end 31 Mar (Rs m)	2005	2006	2007	2008E	2009E	2010E
Gross sales	133,602	162,364	195,200	210,880	243,610	277,139
Less: excise duty	57,546	64,381	72,062	71,289	80,200	89,167
Net sales	**76,056**	**97,983**	**123,138**	**139,591**	**163,411**	**187,972**
Growth (%)	*18.6*	*28.8*	*25.7*	*13.4*	*17.1*	*15.0*
Operating costs	48,530	64,711	83,430	96,234	112,205	128,756
Raw materials consumed	27,757	39,910	53,294	62,959	75,179	87,525
% of sales	36.5	40.7	43.3	45.1	46.0	46.6
Other costs	20,773	24,801	30,136	33,275	37,026	41,232
Operating profit	**27,526**	**33,272**	**39,708**	**43,357**	**51,205**	**59,216**
Growth (%)	*16.6*	*20.9*	*19.3*	*9.2*	*18.1*	*15.6*
Operating margin (%)	36.2	34.0	32.2	31.1	31.3	31.5
Interest expense	424	118	177	89	44	22
Depreciation	3,129	3,323	3,629	4,147	4,845	5,543
Other income	2,358	2,861	3,365	4,192	4,374	5,016
Profit before tax	26,331	32,692	39,267	43,313	50,690	58,666
Extraordinary items	4,859	(63)	363	0	0	0
Taxation	9,276	10,276	12,631	13,427	15,714	18,186
Profit after tax	21,914	22,354	27,000	29,886	34,976	40,480
Adjusted PAT	**18,659**	**22,396**	**26,756**	**29,886**	**34,976**	**40,480**
Growth (%)	*18.9*	*20.0*	*19.5*	*11.7*	*17.0*	*15.7*
Net margin (%)	24.5	22.9	21.7	21.4	21.4	21.5
EPS (Rs)	5.0	6.0	7.1	7.9	9.3	10.8
Dividend	7,733	9,951	11,663	12,227	15,049	16,930
Dividend tax	1,097	1,396	1,982	2,079	2,558	2,878
Total dividend + tax	8,830	11,347	13,645	14,306	17,607	19,808
Payout (%)	47.3	50.7	51.0	47.9	50.3	48.9

Source: Company data, Credit Suisse estimates

Figure 47: **Balance sheet**

Year-end 31 Mar (Rs mn)	2005	2006	2007	2008E	2009E	2010E
Share capital	2,482	3,755	3,762	3,762	3,762	3,762
Reserves and surplus	76,474	86,860	100,609	116,189	133,558	154,230
Loans	2,454	1,197	2,009	1,684	1,664	1,644
Sources of funds	**81,410**	**91,812**	**106,380**	**121,636**	**138,985**	**159,637**
Gross block	57,463	62,272	71,343	83,343	95,343	107,343
Less: depreciation	17,955	20,654	23,895	28,043	32,888	38,431
Net block	39,508	41,617	47,448	55,300	62,455	68,912
Capital work-in-progress	1,862	2,434	8,661	8,661	8,661	8,661
Total investments	38,747	35,170	30,678	48,464	57,757	70,858
Current assets	35,393	51,619	62,897	58,163	66,084	74,418
Inventories	20,030	26,363	33,540	38,230	44,575	51,150
Inventory days	151	149	147	145	145	145
Sundry debtors	5,278	5,480	6,367	6,933	8,009	9,111
Debtor days	14	12	12	12	12	12
Loans & advances	8,104	9,750	12,158	10,000	10,000	10,000
Other current assets	1,425	1,468	1,830	1,500	1,500	1,500
Deferred tax assets	1,974	2,232	2,554	2,554	2,554	2,554
Current liabilities	30,338	35,781	38,576	44,224	51,244	58,485
Sundry creditors	18,878	21,417	23,461	27,598	32,955	38,367
Creditor days	248	196	161	160	160	160
Others (incl. provisions)	11,460	14,364	15,115	16,626	18,289	20,118
Deferred tax liability	5,735	5,479	7,283	7,283	7,283	7,283
Net current assets	1,294	12,591	19,593	9,210	10,112	11,205
Application of funds	**81,410**	**91,812**	**106,380**	**121,636**	**138,985**	**159,637**

Source: Company data, Credit Suisse estimates

Companies Mentioned *(Price as of 24 Jul 07)*

Altria Group, Inc. (MO, $69.80, OUTPERFORM, TP $79.00, MARKET WEIGHT)
Aracruz (ARA, $67.95, NEUTRAL, TP $73.00, UNDERWEIGHT)
BAT Malaysia (BATO.KL, RM 40.75, NEUTRAL, TP RM 42.00)
British American Tobacco (BATS.L, 1621.00p, OUTPERFORM, TP 1800.00p, MARKET WEIGHT)
Carolina Group (CG, $78.66, OUTPERFORM, TP $86.00, MARKET WEIGHT)
EIH (EIHO.BO, Rs105.65, NOT RATED)
Godfrey Phillips India LTd (GDFR.BO, 1357.85, NOT RATED)
GTC Industries (GTC.BO, 235.5, NOT RATED)
Gudang Garam (GGRM.JK, Rp11500.00, NEUTRAL, TP Rp12100.00)
Holmen (HOLMb.ST, SKr293.50, UNDERPERFORM, TP SKr270.00, MARKET WEIGHT)
Hotel Leelaventure (HTLE.BO, 50.75, NOT RATED)
Indian Hotels (IHTL.BO, Rs142.75)
International Paper (IP, $40.30, NEUTRAL, TP $39.00, UNDERWEIGHT)
ITC Ltd (ITC.BO, Rs154.35, OUTPERFORM, TP Rs188)
Japan Tobacco (2914, ¥642,000, NEUTRAL, TP ¥620,000, MARKET WEIGHT)
Kamat Hotels India (KAMT.BO, 171.3, NOT RATED)
Klabin (KLBN4, $3.74, UNDERPERFORM, TP $3.10, UNDERWEIGHT)
KT&G Corp (033780.KS, W72,400, OUTPERFORM, TP W76,000)
M-real (MRLBV.HE, Eu 4.96, OUTPERFORM, TP Eu 7.20, MARKET WEIGHT)
Norske Skog (NSG.OL, NKr85.40, UNDERPERFORM, TP NKr81.00, MARKET WEIGHT)
PepsiCo, Inc. (PEP, $64.67)
Rexam (REX.L, 514.50p, RESTRICTED)
Reynolds American Inc. (RAI, $65.02, NEUTRAL, TP $67.00, MARKET WEIGHT)

Rottneros (RROS.ST, SKr5.35, UNDERPERFORM, TP SKr4.60, MARKET WEIGHT)
Sappi Limited (SPP, $18.00, NEUTRAL, TP $19.00, UNDERWEIGHT)
SCA (SCAb.ST, SKr113.25, NEUTRAL, TP SKr130.30, MARKET WEIGHT)
Stora Enso (STERV.HE, Eu 13.66, NEUTRAL, TP Eu 14.00, MARKET WEIGHT)
Suzano (SUZB5, $14.79, OUTPERFORM, TP $17.00, UNDERWEIGHT)
Swedish Match (SWMA.ST, SKr138.00, NEUTRAL, TP SKr138.00, MARKET WEIGHT)
Taj GVK Hotels & Resorts (TAJG.BO, 172.7, NOT RATED)
UPM-Kymmene (UPM1V.HE, Eu 18.01, OUTPERFORM, TP Eu 23.70, MARKET WEIGHT)
UST Inc. (UST, $53.83, UNDERPERFORM, TP $49.50, MARKET WEIGHT)
Votorantim (VCP, $25.95, OUTPERFORM, TP $28.00, UNDERWEIGHT)
VST Industries (VSTI.BO, 368.15, NOT RATED)

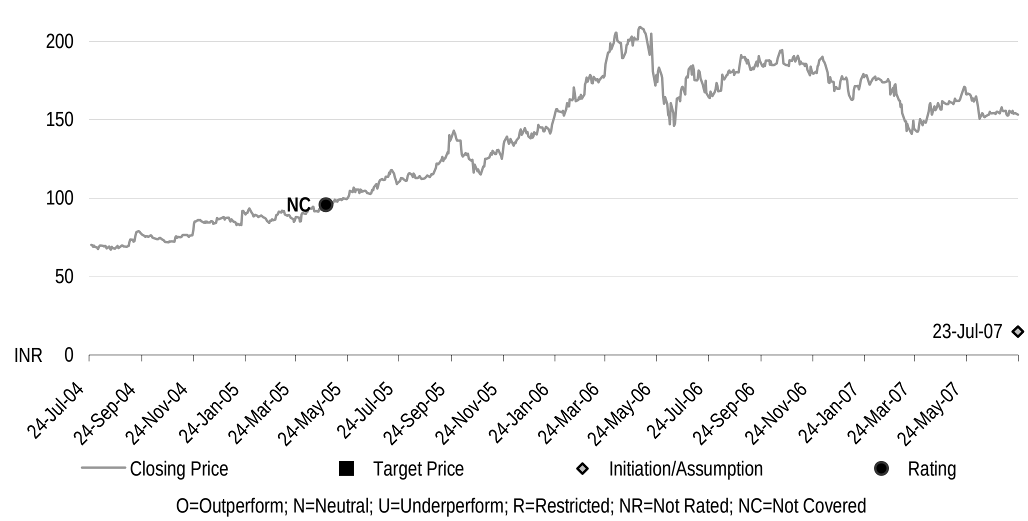
Disclosure Appendix

Important Global Disclosures

I, Govindarajan Chellappa, certify that (1) the views expressed in this report accurately reflect my personal views about all of the subject companies and securities and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

See the Companies Mentioned section for full company names.

3-Year Price, Target Price and Rating Change History Chart for ITC.BO



ITC.BO Date	Closing Price Price (INR)	Target Price Price (INR)	Rating	Initiation/ Assumption
29-Apr-05	95.82		NOT COVERED	
23-Jul-07				X

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Price Target: (12 months) for (ITC.BO)

Method: We value ITC on a sum of the parts method to capture the value created by various businesses. Our SOTP target price of Rs188 assigns a value of Rs110 to the cigarette business, based on global average one-year forward PE multiple of 16.5x FY09E. Paper (Rs15 per share, 2x FY08E BV) and hotel businesses (Rs21, 3.5x FY08E BV) are valued on P/B Vs RoE comparatives while FMCG business (Rs25, 3x FY09E sales) is valued on P/Sales. At our target price, ITC would trade at 20.2x FY09E, in line with long-term historic average multiple.

Risks: The key risks to our target price of Rs188 arises from risks to the valuation of various businesses. Risk to cigarette business is primarily from possible increase in taxes by the government, as well as regulatory actions. Risks to paper and hotel businesses are primarily cyclical in nature. Execution risks exist in other new ventures, including FMCG.

Important Regional Disclosures

The analyst(s) involved in the preparation of this report have not visited the material operations of the subject company (ITC.BO) within the past 12 months.

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