

# Expectations running high

## We expect ITC's cigarette volumes to decline in Sept Q

We believe ITC's cigarette performance in Sept Q will not live up to market's expectations. Contrary to popular belief, we estimate ITC's volumes in Sept Q are down 3-4% y-o-y. We also believe that Sept Q volumes are lower than June Q as the latter had the hit of higher prices for only 2 months. Secondly, Sept Q also bears the full brunt of Uttar Pradesh tax of 32%. We remind investors UP accounts for 6% of ITC's volumes and has not implemented VAT of 12.5%.

## No change in our full year volume and profit estimates

ITC's Sept Q volume trends are similar to those witnessed in June Q. As a result there is no change to our full year cigarette volume decline of 4% in FY08. Next year, we forecast volume gain of 5% on the back of tax increase of 5%. We note however, that visibility for FY09 is poor as cigarette taxation has witnessed fundamental deterioration – it has moved from a Central level to a State level.

## New shampoo launched, more HPC products in the pipeline

ITC's recent shampoo launch marks its entry in the household and personal care (HPC) category. The brand, *Fiamma Di Wills* has been launched in six SKUs and is priced in between HUL's *Sunsilk* and *Clinic All Clear*. We believe next in the pipeline are shampoo sachets and soaps. These events imply that ITC's FMCG losses (5% of EBIT) are unlikely to decline in the near future.

## Reiterate Neutral on fair valuation

We forecast ITC's profit to grow ~15% over the next two years and believe valuations appear fair at 20x FY09E EPS. Relative to the Sensex, it is trading at ~20% P/E premium which is in line with its 10-year average.

### Estimates (Mar)

(Rs)	2006A	2007A	2008E	2009E	2010E
Net Income (Adjusted - mn)	22,792	27,000	31,126	35,207	39,304
EPS	6.07	7.18	8.27	9.36	10.45
EPS Change (YoY)	23.8%	18.2%	15.3%	13.1%	11.6%
Dividend / Share	2.07	2.65	3.10	3.72	4.21
Free Cash Flow / Share	3.53	1.21	4.38	5.54	6.40
GDR EPS (Rs)	6.07	7.18	8.27	9.36	10.45
GDR Dividend / Share (Rs)	2.07	2.65	3.10	3.72	4.21

### Valuation (Mar)

	2006A	2007A	2008E	2009E	2010E
P/E	30.79x	26.04x	22.58x	19.97x	17.89x
Dividend Yield	1.11%	1.42%	1.66%	1.99%	2.25%
EV / EBITDA*	20.25x	16.59x	14.55x	12.93x	11.64x
Free Cash Flow Yield*	1.89%	0.646%	2.34%	2.96%	3.43%
Adjusted BV	NA	NA	NA	NA	NA

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 3.



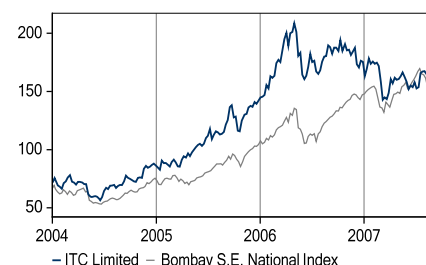
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### Stock Data

Price (Common / GDR)	Rs186.85 / US\$4.54
Investment Opinion	C-2-7 / C-2-7
Volatility Risk	HIGH / HIGH
52-Week Range	Rs140.15-Rs196.45
Market Value (mn)	US\$17,485
Shares Outstanding (mn)	3,762.2 / 3,762.2
Average Daily Volume	1,217,543
ML Symbol / Exchange	ITCTF / BSE
ML Symbol / Exchange	XTILF / LUX
Bloomberg / Reuters	ITC IN / ITC.BO
ROE (2008E)	28.0%
Net Dbt to Eqty (Mar-2007A)	-6.7%
Est. 5-Yr EPS / DPS Growth	15.0% / 15.0%
Free Float	67.0%



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Refer to important disclosures on page 4 to 5. Analyst Certification on page 3.

# *iQprofile*<sup>SM</sup> ITC Ltd.

## Key Income Statement Data (Mar)

(Rs Millions)	2006A	2007A	2008E	2009E	2010E
Sales	97,894	123,659	144,600	168,238	196,409
Gross Profit	42,957	53,062	61,058	69,539	78,638
Sell General & Admin Expense	(9,695)	(12,458)	(14,743)	(17,417)	(20,783)
Operating Profit	29,939	36,981	42,361	47,719	52,988
Net Interest & Other Income	2,742	2,286	2,749	3,306	3,974
Associates	NA	NA	NA	NA	NA
Pretax Income	32,680	39,267	45,110	51,024	56,962
Tax (expense) / Benefit	(9,888)	(12,267)	(13,984)	(15,818)	(17,658)
Net Income (Adjusted)	22,792	27,000	31,126	35,207	39,304
Average Fully Diluted Shares Outstanding	3,755	3,762	3,762	3,762	3,762

## Key Cash Flow Statement Data

Net Income (Reported)	22,792	27,000	31,126	35,207	39,304
Depreciation & Amortization	3,323	3,623	3,955	4,403	4,866
Change in Working Capital	(5,591)	(8,878)	(4,620)	(4,777)	(6,090)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(1,255)	(1,503)	0	0	0
Cash Flow from Operations	19,270	20,242	30,461	34,833	38,080
Capital Expenditure	(6,013)	(15,702)	(14,000)	(14,000)	(14,000)
(Acquisition) / Disposal of Investments	(256)	(511)	0	0	0
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	(6,269)	(16,213)	(14,000)	(14,000)	(14,000)
Shares Issue / (Repurchase)	NA	NA	NA	NA	NA
Cost of Dividends Paid	(8,817)	(11,347)	(16,080)	(18,188)	(20,304)
Cash Flow from Financing	(8,162)	(10,111)	(16,080)	(18,188)	(20,304)
Free Cash Flow	13,257	4,541	16,461	20,833	24,080
Net Debt	(7,361)	(6,993)	(7,374)	(10,019)	(13,794)
Change in Net Debt	(6,095)	6,893	(381)	(2,645)	(3,776)

## Key Balance Sheet Data

Property, Plant & Equipment	43,460	55,538	65,584	75,181	84,315
Other Non-Current Assets	35,170	30,678	30,678	30,678	30,678
Trade Receivables	5,480	6,367	7,923	9,219	11,300
Cash & Equivalents	8,558	9,002	9,382	12,027	15,803
Other Current Assets	37,581	47,529	54,607	62,558	71,891
Total Assets	130,249	149,113	168,175	189,662	213,987
Long-Term Debt	1,197	2,009	2,009	2,009	2,009
Other Non-Current Liabilities	3,248	4,729	4,729	4,729	4,729
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	35,781	38,576	42,591	47,060	52,385
Total Liabilities	40,226	45,313	49,328	53,797	59,122
Total Equity	90,023	103,800	118,846	135,865	154,865
Total Equity & Liabilities	130,249	149,113	168,175	189,662	213,987

## *iQmethod*<sup>SM</sup> - Bus Performance\*

Return On Capital Employed	23.3%	24.8%	24.8%	24.6%	24.0%
Return On Equity	27.1%	27.9%	28.0%	27.6%	27.0%
Operating Margin	30.6%	29.9%	29.3%	28.4%	27.0%
EBITDA Margin	34.0%	32.8%	32.0%	31.0%	29.5%

## *iQmethod*<sup>SM</sup> - Quality of Earnings\*

Cash Realization Ratio	0.8x	0.7x	1.0x	1.0x	1.0x
Asset Replacement Ratio	1.8x	4.3x	3.5x	3.2x	2.9x
Tax Rate (Reported)	30.3%	31.2%	31.0%	31.0%	31.0%
Net Debt-to-Equity Ratio	-8.2%	-6.7%	-6.2%	-7.4%	-8.9%
Interest Cover	NM	NM	NM	NM	NM

## Key Metrics

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 3.

## Company Description

ITC is India's largest cigarette company with about 70%+ volume share and 85%+ value share. Cigarettes account for 59% of turnover and 89% of EBIT. The company has diversified into non-tobacco businesses, such as consumer products, apparel retailing, hotels, paper, and agricultural exports. Key strengths: (1) extensive distribution, (2) strong brands across price segments, and (3) a healthy balance sheet.

## Stock Data

Shares / GDR	1.00
Price to Book Value	5.9x

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### *iQmethod*<sup>SM</sup> Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Other LT Liabilities}$	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

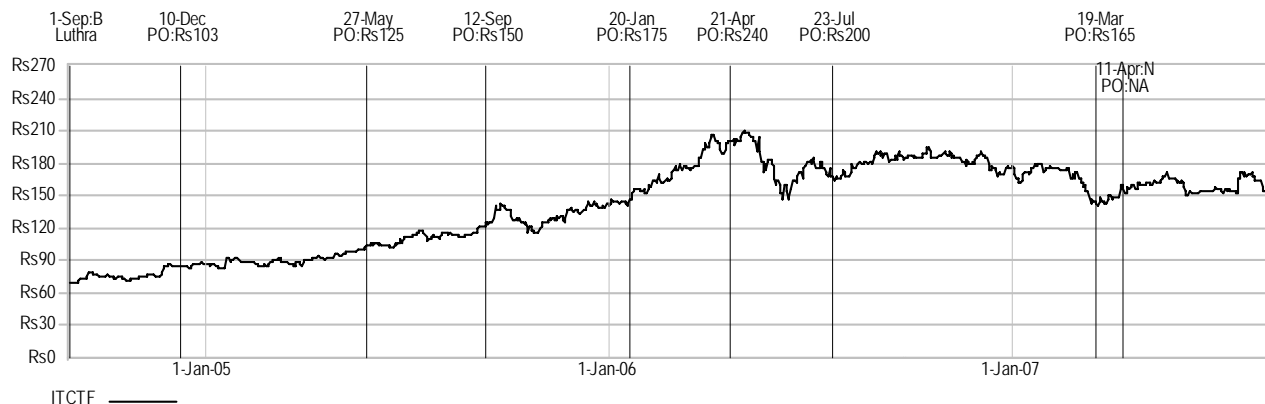
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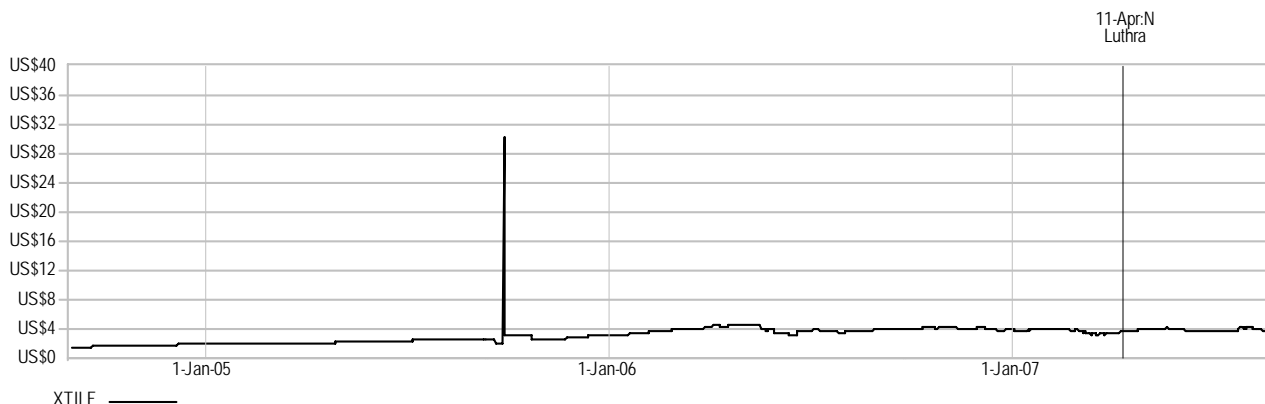
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B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of August 30, 2007 or such later date as indicated.

### XTILF Price Chart



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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	55	57.89%	Buy	7	14.00%
Neutral	36	37.89%	Neutral	5	19.23%
Sell	4	4.21%	Sell	1	33.33%

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Buy	1675	47.16%	Buy	435	29.21%
Neutral	1633	45.97%	Neutral	438	29.67%
Sell	244	6.87%	Sell	47	21.66%

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