FMCG Sector

Large cap FMCG on the prowl....

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Contents

Executive summary

- The Indian FMCG sector is witnessing an uptrend in demand growth with a rise in disposable income levels supported by consistent growth in GDP.
- The positive factor in the current rise in income levels is that it is broad based.
- This broad-based growth in income levels has led to acceleration in demand from both the urban and rural markets. However, in the rural markets, the demand growth is more visible due to the low base effect.
- Rural demand growth has been aided by higher industrialisation and improving infrastructure, leading to the creation of semi-urban markets, in addition to the positive growth in agriculture and shift in agricultural output towards value-added products.
- In a scenario of favourable demand, the pricing environment has also improved.
- Going forward, with a higher number of people in the key consuming class and the existing low per capita consumption, we estimate that FMCG demand will grow at about 8-9% per annum in the medium term.
- Future consumption growth would be led by rising income levels across the urban and rural markets and we believe that this would benefit FMCG companies with deep and broad-based penetration in these markets and a comprehensive product portfolio to service these markets.

Executive summary (contd…)

- We believe that HUL and ITC are the best placed FMCG companies in a scenario of broad-based growth.

- HUL has a strong portfolio, spanning across key categories in Home and Personal Care and Foods, with one of the largest distribution network reaching 6.3mn outlets spread across 638,000 villages. Additionally, it has its network of 45,000 Shakti Ammas in 10,000 small villages across 15 states in India reaching over 3 mn homes.

- ITC is well placed to capitalise on the India opportunity with its growing packaged foods business in addition to its strong comprehensive presence in cigarettes. In addition, the company's foray in to personal care may provide it the right product portfolio to tap the rural markets with its strong procurement and distribution network (Choupal).

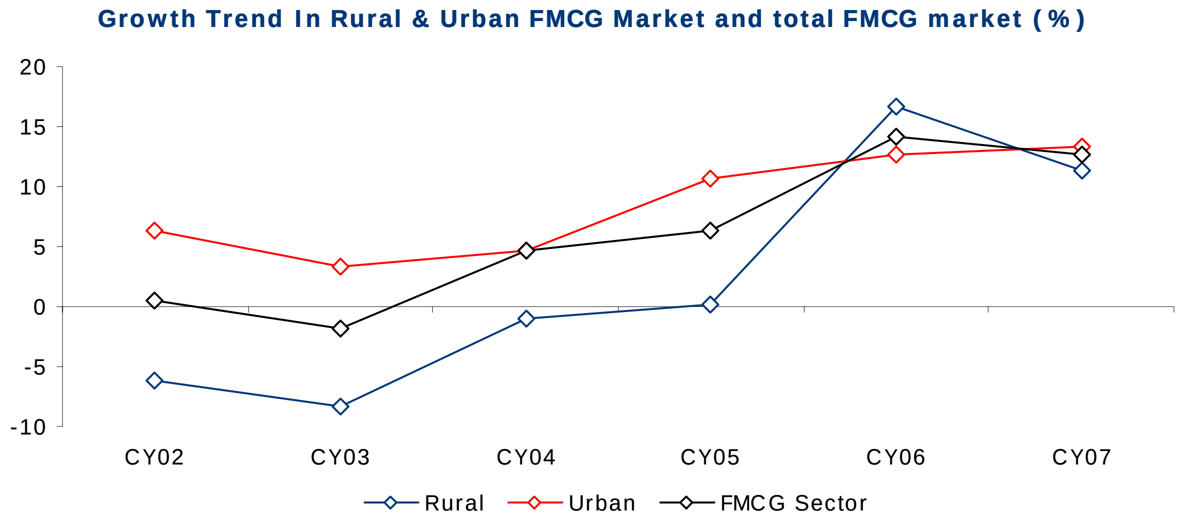
- We, therefore, recommend a BUY on the large cap FMCG arena, HUL and ITC with expected appreciation in stock prices to the tune of 17% and 13%, respectively.

Relative Valuation

		HUL	ITC	Marico	Dabur	Colgate
Sales, Rs mn	FY07	121,034	123,693	15,569	21,966	12,951
	FY08E	137,178	140,623	19,208	25,287	14,748
	FY09E	155,517	165,493	22,255	29,340	16,766
EBITDA, Rs mn	FY07	16,481	39,564	2,126	3,497	2,021
	FY08E	18,857	44,232	2,487	4,150	2,487
	FY09E	22,759	52,597	3,027	4,949	2,998
PAT, Rs mn	FY07	15,399	27,000	1,129	2,822	1,854
	FY08E	17,674	31,413	1,687	3,467	2,300
	FY09E	20,502	36,686	1,972	4,083	2,800
EPS, Rs	FY07	7.1	7.2	2.0	3.3	11.8
	FY08E	8.1	8.3	2.8	4.0	16.9
	FY09E	9.4	9.7	3.2	4.7	20.6
P/E, x	FY07	32.4	28.8	34.7	33.8	32.5
	FY08E	28.2	24.7	24.5	27.5	22.6
	FY09E	24.3	21.2	20.9	23.4	18.6
EV/EBITDA, x	FY07	30.4	19.5	20.4	27.6	25.2
	FY08E	26.4	17.0	16.6	22.5	20.6
	FY09E	21.8	14.1	13.5	18.5	16.9
RoCE, %	FY09E	76.7	26.3	30.4	44.5	135.6
Mcap/Sales, x	FY07	3.9	6.3	2.7	4.3	3.8
	FY08E	3.4	5.5	2.1	3.7	0.3
	FY09E	3.0	4.7	1.9	3.2	0.3

Source: Company, MF Global India Research Estimates

FMCG demand has grown due to broad-based growth across markets

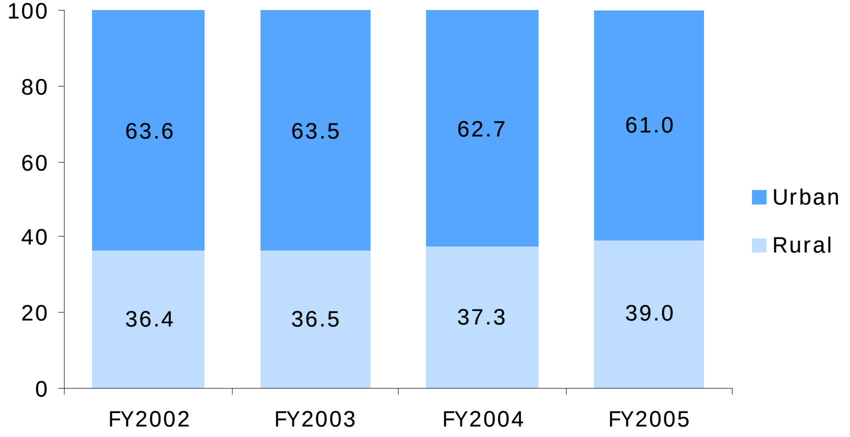


- The FMCG demand scenario in India has improved from CY04 with accelerated growth across the urban and rural markets.
- The differentiating factor has been the growth in rural markets, which has picked up during the last four years from a negative growth.
- Consistent growth in disposable income levels, in both the urban and rural markets, has triggered the accelerated growth in FMCG demand.

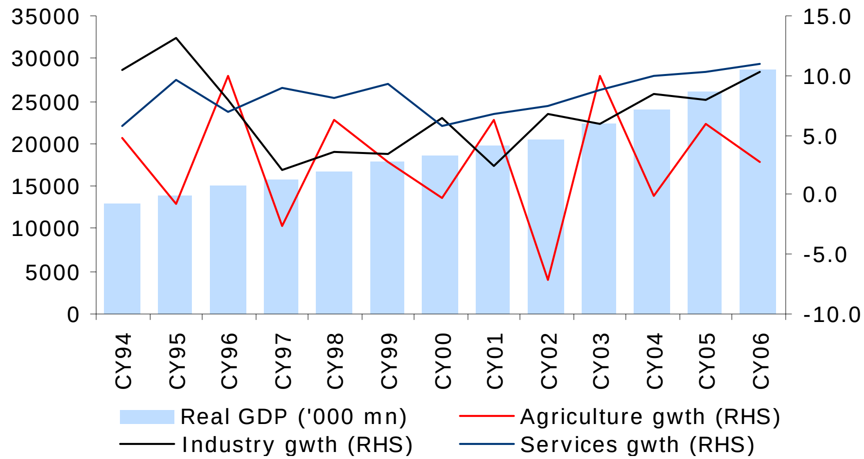
Source: Industry ,MF Global India Research Estimates

Consistent growth in GDP and higher urbanisation is leading to a rise in income levels and consumption growth

Factory setup in India (%)

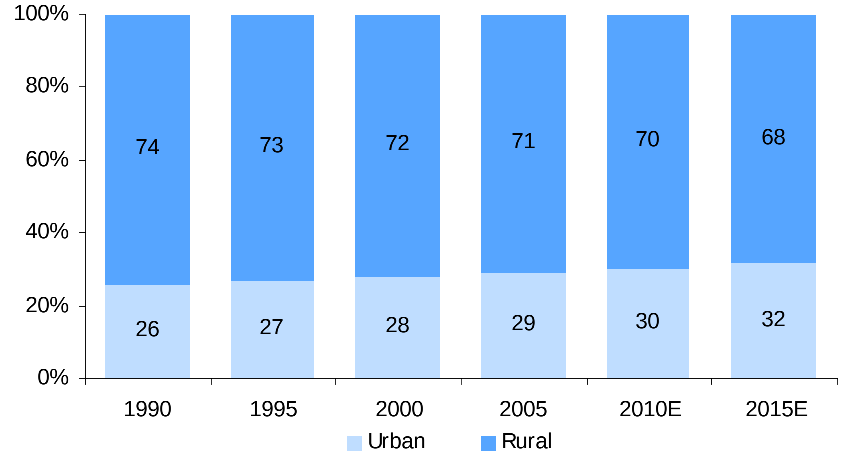


Sector-wise GDP Growth (%)



- Broad-based growth in income levels have been aided by consistent growth in GDP.
- GDP growth has been primarily aided by accelerated growth in services and industrialisation. This, in turn, has benefited urban income levels.
- Apart from aiding urban income levels, industrialisation has also facilitated growth in rural incomes. About 39% of the total factories in India were located in rural markets in FY05 against 36.4% in FY02.
- The higher industrialisation has led to higher urbanisation. However, the same is not reflected in the growth in urbanisation.

Trend in Urbanisation

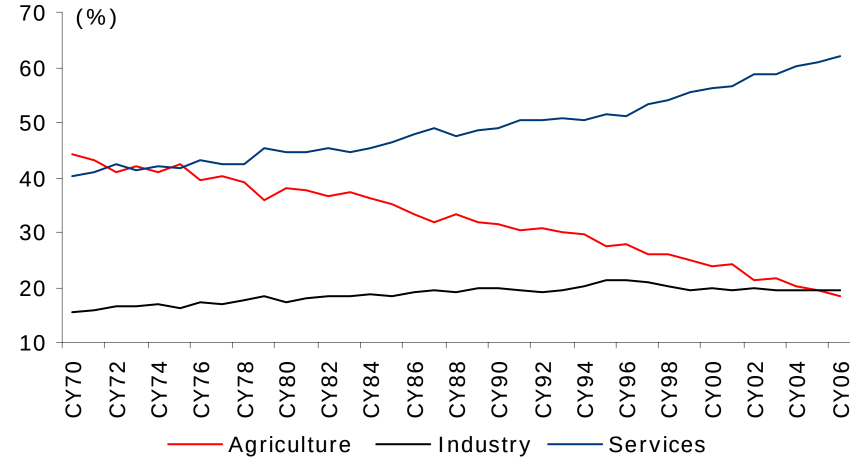


Source: Cris INfac, MF Global India Research Estimates

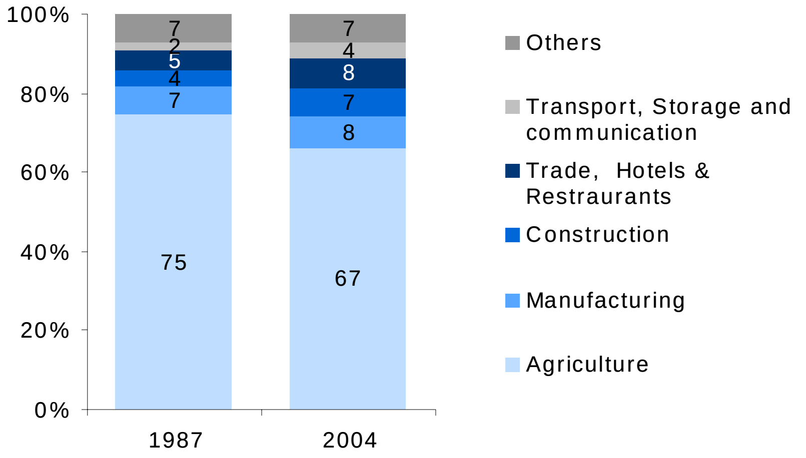
Shift towards non-agri income has aided rural demand

- Higher industrialisation and consequent creation of infrastructure has actually created semi-urban markets, currently classified as rural markets.
- The growth in contribution of other sectors to rural employment is a fair indication of the lowering dependence on agriculture in the rural markets.
- The growing contribution of services and industries and the reducing contribution of agriculture to GDP is also a fair indication of the growing significance of industries and services even in rural markets.

Sector-wise Contribution To Real GDP



Shift of Rural employment from agriculture



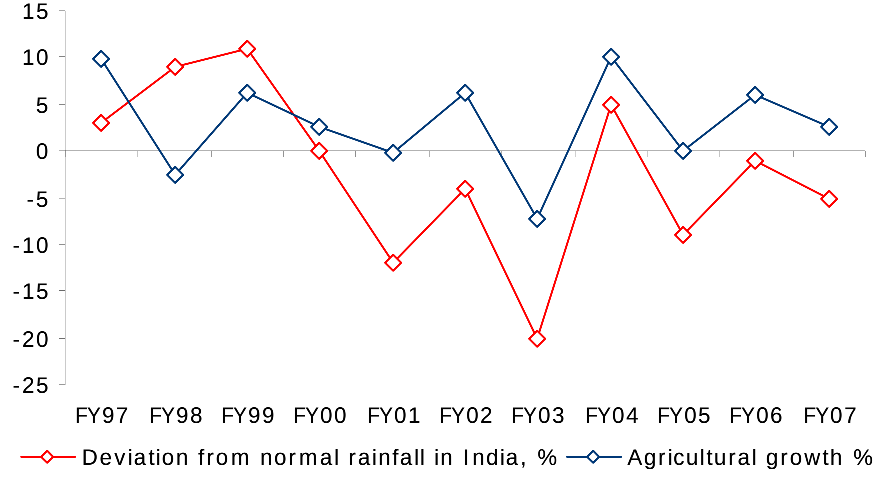
Source: MGI, MF Global India Research

Nevertheless, positive agri growth has also driven rural demand

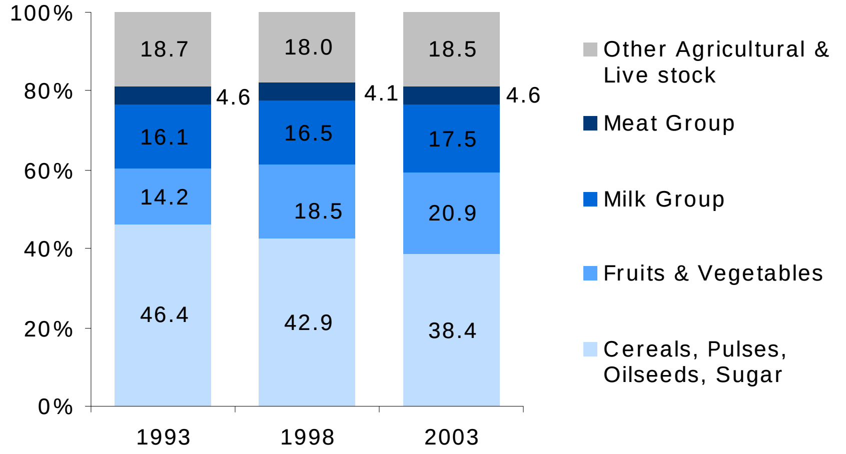
FMCG Sector

- Nevertheless, agriculture still remains a significant portion of the rural economy and rural consumption.
- Therefore, the positive growth in agriculture during the last four years has had a favourable impact on rural income levels and consumption growth.
- Growth in agriculture has been aided by favourable monsoons during the last four years.
- In addition to the shift in rural employment to non-agri sectors, activities within agriculture have also shifted towards value-added products. This is expected to have improved the overall profitability of agriculture leading to higher income levels in rural markets.

Trend in agriculture growth & deviation from normal Monsoon



Agriculture activities transferring into higher value-added activities

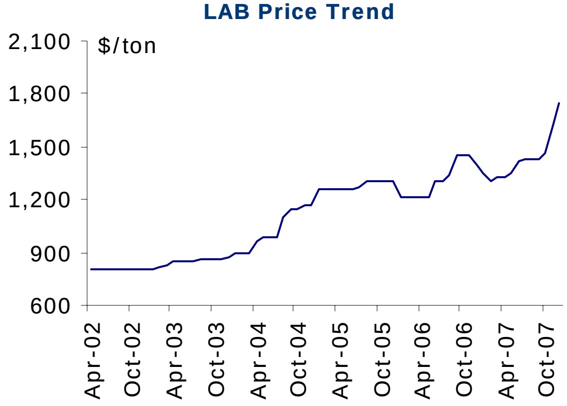


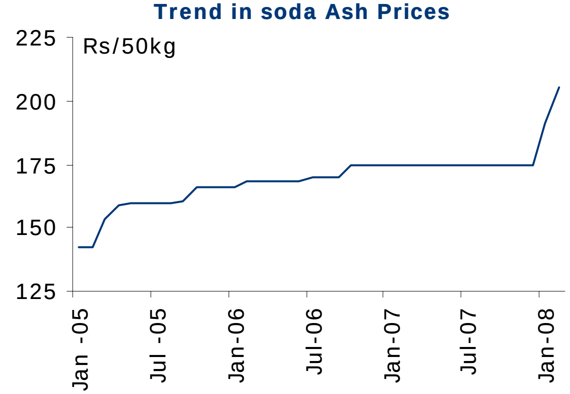
MF Global

Source: MGI, MF Global India Research Estimates

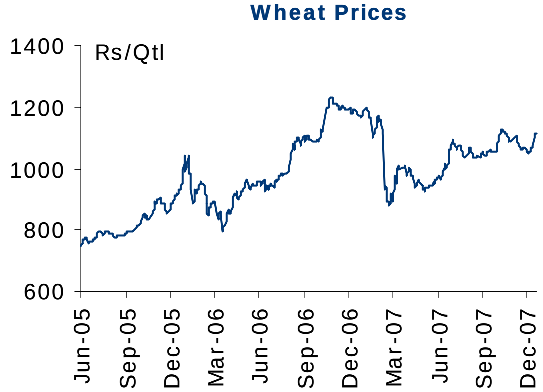
Better pricing scenario and improving product mix comes as a positive against rising input cost

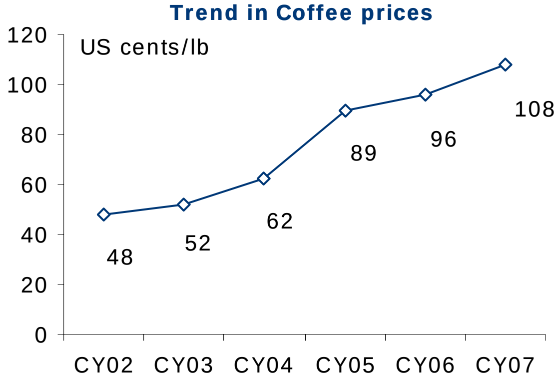
- The better demand scenario in FMCG has led to favourable product pricing, which enables passing on of the rise in input cost pressure.
- Up-trading within product categories, led by a rise in income levels, particularly in the urban markets, has led to an improved product mix, which again has helped in curbing the impact of input cost inflation.





Category	Price Hike
Soaps	8%-10%
Detergents	10%-12%
Shampoos	4%-5%
Skin Creams	5%-7%
Toothpaste	4-5%
Edible Oil	7%-8%
Tea	4%-5%
Coffee	5%-6%
Noodles	4%-5%
Health Drinks	5%-7%





Source: MCX, Bloomberg, Cris Infac, MF Global India Research

Going forward, rising income levels and increase in per capita consumption would drive growth

Per Capita Consumption (US$ per annum)

Category	India	China	U.S	Brazil	Indonesia
Personal Wash	1.0	0.5	4.3	6.7	0.7
Oral Care	0.6	1.4	18.9	10.0	1.5
Detergents	1.4	2.2	22.9	12.1	1.9
Shampoo	0.3	1.0	6.7	6.0	1.0
Skin Care	0.3	3.2	26.9	12.2	0.8
Tea	0.8	0.4	5.5	1.0	2.4
Coffee	0.2	0.2	22.9	15.0	1.0
Ice cream	0.2	3.0	49.4	5.9	1.0

Penetration (%)

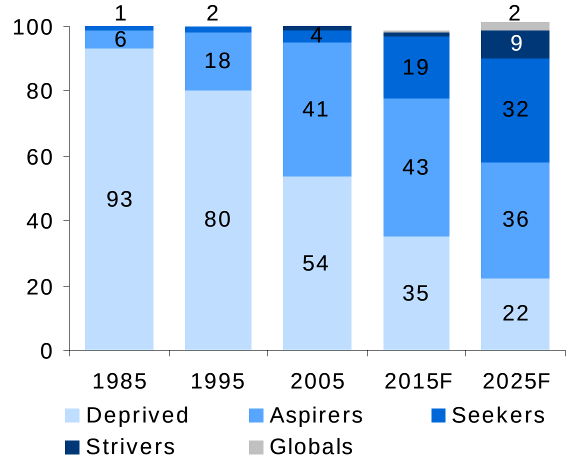
Category	All India	Urban	Rural
Deodorant	2.1	5.5	0.6
Toothpaste	48.6	74.9	37.6
Skin Cream	22.0	31.5	17.8
Shampoo	38.0	52.1	31.9
Utensil Cleaner	28.0	59.9	14.6
Instant Coffee	6.6	15.5	2.8
Washing Powder	86.1	90.7	84.1
Detergent Bar	88.6	91.4	87.4
Toilet Soap	91.5	97.4	88.9

- Overall per capita consumption levels in FMCG categories remain low and even in categories where the penetration levels are high, consumption levels are low.
- A key reason for the lower consumption levels could be the high rate of deprived population, which are relatively marginal consumers of branded products.

Source: Industry, MF Global India Research Estimates

FMCG demand estimated to grow by 6-7% per annum

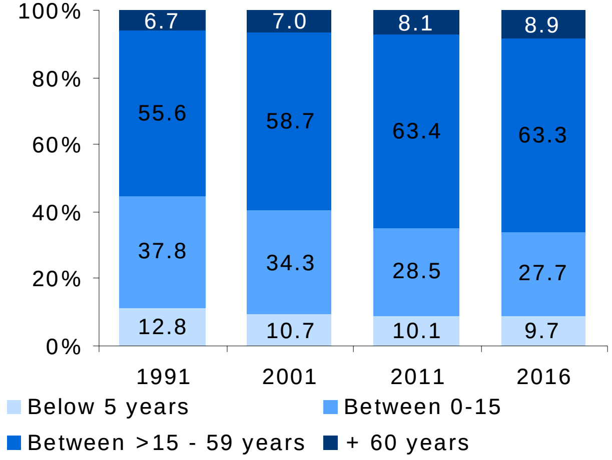
Share of Population (%)



Segregation of Class based on annual Income

Income class	Annual Income (Rs)
Deprived	<90000
Aspirers	90000-200000
Seekers	200000-500000
Strivers	500000-1000000
Global Indians	1000000+

Composition of population by age



- Going forward, we believe that the increase in income levels and resultant higher number of people in the key consuming class (excluding deprived population) **would result in demand growth of 6% per annum for the key consuming class by FY15**. According to Mckinsey estimates, about 322mn people would be added to the total key consuming class**. Total FMCG demand is estimated to grow by about 3-4% CAGR by FY15.**
- Further, accounting for an inflation rate of 3-4%, we estimate the total value growth in the key consuming class in FMCG to be at 9-10% during FY08-FY15, while the total FMCG demand (including inflation) is estimated to grow by 6-7% CAGR during the period.
- In addition to the growth in income class, the increase in working population (15-64) would also aid consumption growth in FMCG. According to estimates, about 281mn people would be added to the working population by 2016.

Source: MGI, MF Global India Research Estimates

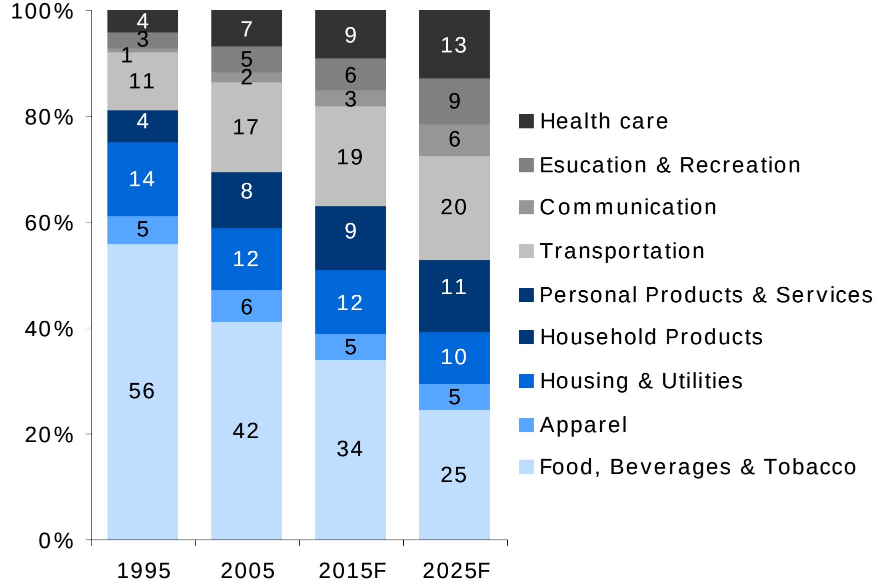
Growth in personal products to be higher over category

- Higher disposable income for the existing consumer class would result in higher demand for low-penetration categories of personal products.

- According to MGI, personal products would witness an increase in its contribution in average household consumption from 8% in 2005 to 9% in 2015 and 11% in 2025, thus indicating a higher growth over the normal consumption growth in other categories.

- Therefore, we could witness a better growth in higher realisation product categories which, in turn, would translate into an improved product mix and higher value growth for FMCG companies.

Share of Expenditure



Source: MGI, MF Global India Research Estimates

Growth to be broad based, requiring presence across markets

- In the medium to long term (10-20 years), growth in disposable income levels is expected to be broad based, though it is expected to be higher in urban markets.

- According to MGI estimates, urban average disposable income levels are expected to grow by 5.8% CAGR in 2005-2025 against 4.6% CAGR in 1985 to 2005, rural markets would grow at a higher rate of 3.6% CAGR during 2005-2025 against 2.8% CAGR in 1985-2005.

- Growth in urban income levels would be led by continued growth in services and manufacturing.

- Growth in the rural income levels would be led by higher demand for agricultural products from the urban markets, better infrastructure in terms of irrigation and connectivity with urban markets.

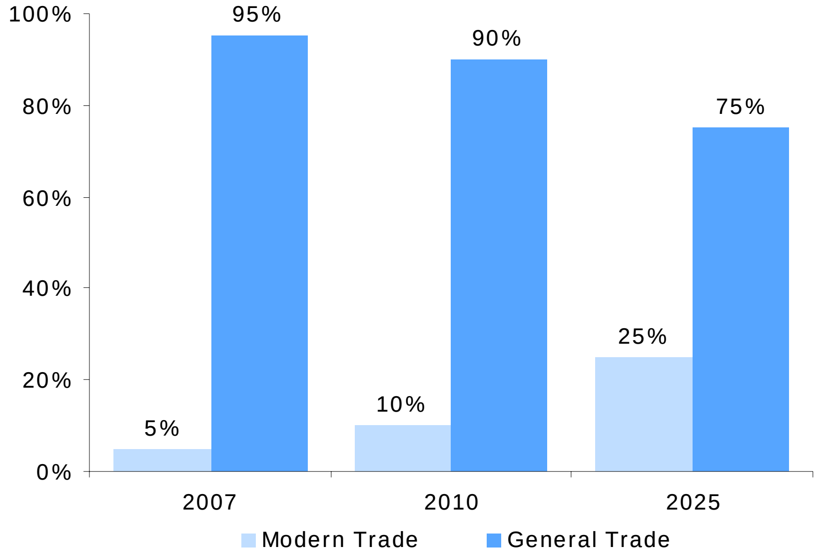
- As the total deprived population in India is expected to drop from 54% in 2005 to 22% in 2025, the rural deprived is expected to drop from 65% in 2005 to 29% in 2025.

- Therefore, FMCG companies with wide product baskets and an extensive distribution network spread across urban and rural markets would benefit the most.

Presence in modern retail important too…

- Modern retail is estimated to grow at about 15-20% per annum during the next 10-15 years aided by growth in urban income levels.
- Resultantly, modern retail is expected to increase its contribution to total trade from about 5% in 2007 to about 10% in 2010 and about 25% in 2015
- Growth in modern trade would be a positive for FMCG demand growth, as the same would expand and create market for innovative and value added products. This in turn would increase realizations and on an overall basis, aid profitability, despite expectations of loss of margins to modern retail.
- Therefore a strong presence in modern trade would also be a differentiating factor for FMCG companies, particularly in the urban markets.

Share of Modern Trade



Source: Industry, MF Global India Research

Larger FMCG companies to benefit

- Large FMCG players like HUL and ITC with comprehensive product portfolios and well-penetrated distribution strength, both in the urban and rural markets, are expected to get the highest benefit from the broad based growth.

- **Product portfolio**
  - HUL has a dominating presence across major price points in the home and personal care, beverages, processed foods and ice creams.
  - ITC has a dominating presence in cigarettes and is ramping up operations in personal care after creating a presence in packaged foods (biscuits and atta).

- **Distribution network**
  - HUL has a strong distribution network of 6.3mn outlets spread across 638,000 villages. In addition, the company has set up a network known as Shakti Ammas (currently 45,000) across more than 100,000 villages in 15 states and reaching 3mn households.
  - ITC, in addition to its distribution reach through cigarettes, has established a presence in the groceries channel through packaged foods and more importantly, is establishing a strong network of rural distribution through its choupal network.
  - **Existing rural distribution of ITC**
    - E-choupals–6500
    - Choupal sagars–21 (spread across Madhya Pradesh, U.P. and Maharastra.)

Companies Section

Hindustan Unilever – Regaining lost ground (BUY)
(CMP Rs 229 / MCap US$ 12.4bn / Target Price Rs 268)

ITC – *Play on an emerging economy's pricing strength* (BUY)
(CMP Rs 206 / MCap US$ 19.4bn / Target Price Rs 234)

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INITIATING COVERAGE

March 31, 2008

Hindustan Unilever (HLVR IN / HLL.BO)

BUY

Regaining lost ground….

CMP Rs 229
Tgt Rs 268 (+17%)

This note should be read for
- *Estimated price hikes and growth across brands and categories*
- *Estimated improvement in profitability in soaps and detergents and personal products*
- *Estimated growth within personal products*

Investment Rationale

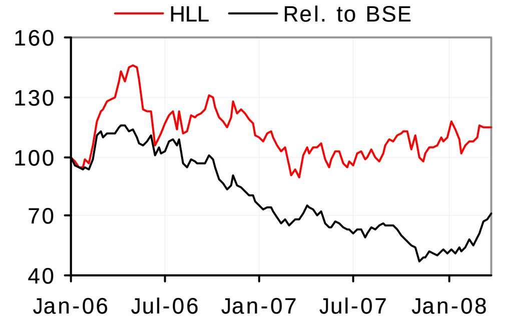
- Revival in a high-penetration category like detergents comes as a positive for the company, providing it the opportunity to invest in its low-penetration businesses.
- Margins of soap and detergents to improve by 78bps in CY08 and by 35bps in CY09, led by margin expansion in detergents.
- Personal products expected to continue with the revival witnessed during Q4CY07, led by higher sales of skin care and better growth in oral care.
- Beverages growth to be led by higher growth in tea, backed by renewed focus and brand-spends.
- Packaged foods and ice creams to be driven by product innovation and higher distribution.

Risks

- Sharp growth in palm oil, LAB and Soda Ash prices could put intense pressure on margins.
- With global players like Nivea increasing their focus on India, competition in personal care may intensify.
- ITC's foray in the personal care segment may increase competition in the medium to long term, requiring higher ad-spends.

Valuation

- The stock is trading at a PE of 24.4x CY08 earnings and 21.2x CY09 earnings. We believe that the stock would be re-rated in an environment of rising disposable incomes, favouring broad-based consumption growth. We recommend a BUY on the stock with a price target of Rs 268.



Company data	
O/S shares :	2208mn
Market cap (Rs) :	498bn
Market cap (USD) :	12.4bn
52 - wk Hi/Lo (Rs) :	248 / 170
Avg. daily vol. (3mth) :	2.8mn
Face Value (Rs) :	1

Share holding pattern, %	
Promoters :	52.1
FII / NRI :	14.6
FI / MF :	15.4
Non Pro. Corp. Holdings :	1.1
Public & Others :	16.8

Y/E Dec, Rs bn	CY07	CY08E	CY09E
Net Sales	137.2	154.5	173.2
PAT	18.1	20.4	23.5
EBIDTA mrg, %	13.7	14.6	15.1
PAT mrg, %	13.2	13.2	13.6
ROE, %	87.2	130.1	123.2
EPS, Rs	8.3	9.4	10.8
PER, x	27.5	24.4	21.2

Investment Overview

Sustainable competitive advantage	Strong and comprehensive presence across HPC and Foods with one of the most penetrated distribution networks in the Indian FMCG arena
Financial structure	Low gearing due to strong free cash flow generation
Shareholder value creation	Consistent improvement in return ratios with growth in asset turnover. Strong dividend payout ratio of 74.4%, implying a dividend yield of 4.4% CY08E
Earnings visibility	Earnings growth of about 14-15% would be comfortably achieved in a scenario of rising income levels, which provides the opportunity to hike prices.
Valuation	At the CMP of Rs 229, the stock trades at a PE of 24.4x CY08E and 21.2x CY09E earnings and at an EV/EBIDTA of 21.9x CY08E and 18.8x CY09E earnings. We believe that the stock would be re-rated with continued revival in key categories.
MF Global vs. consensus	Our CY08E estimates are in line with consensus estimates.
Future event triggers	Accelerated growth in personal products and higher-than-expected improvement in soaps and detergents would be positive triggers for the stock in the short term.

Valuation Summary

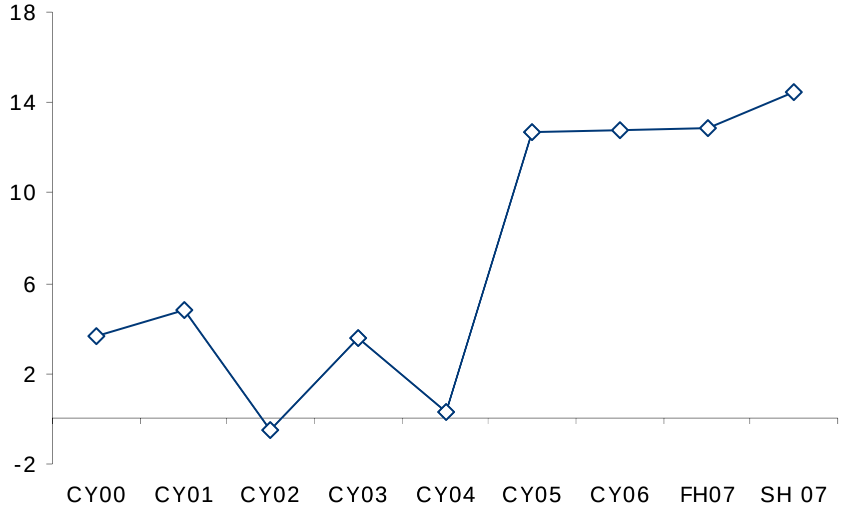
Y/E Dec, Rs mn	CY2005	CY2006	CY2007	CY2008E	CY2009E
Total Income	110,605	121,034	137,178	154,541	173,158
Total income Growth, %	11.4	9.4	13.3	12.7	12.0
Core EBIDTA	14,433	16,481	18,857	22,633	26,167
EBIDTA margins, %	13.0	13.6	13.7	14.6	15.1
Net profit	13,447	15,399	18,148	20,402	23,524
PAT margins, %	12.2	12.7	13.2	13.2	13.6
EPS, Rs	6.2	7.1	8.3	9.4	10.8
EPS Growth, %	13.1	14.5	17.9	12.4	15.3
PER, x	37.1	32.4	27.5	24.4	21.2
EV/EBIDTA, x	34.3	30.0	26.4	21.9	18.8
EV/Net Sales, x	4.5	4.1	3.6	3.2	2.8
Price/Book Value, x	21.6	18.3	34.6	29.4	23.5
ROIC, %	88.0	127.4	141.5	171.0	193.5
ROE, %	61.1	61.2	87.2	130.1	123.2
Dividend Yield, %	2.2	2.7	4.0	4.4	4.6

Source: MF Global India Research Estimates

HUL's FMCG business witnesses revived growth in key categories

- HUL's FMCG business, which comprises of home and personal care, has witnessed renewed growth in the last four years.
- Growth has been primarily led by growth in its key categories-soaps and detergents and personal products.
- Soaps and detergents, despite high penetration levels have recorded growth of 12.6% CAGR during CY04-CY07. Particularly, in the last three years (CY05-CY07), post the price cuts in detergents, the business has grown at a higher rate of 13.6% CAGR backed by improving volume growth.
- Personal products have grown by about 14.1% during CY04-CY07. However, growth in the last two years has witnessed a slowdown in the category, with signs of revival in the last quarter of CY07.

HUL FMCG Growth (%)



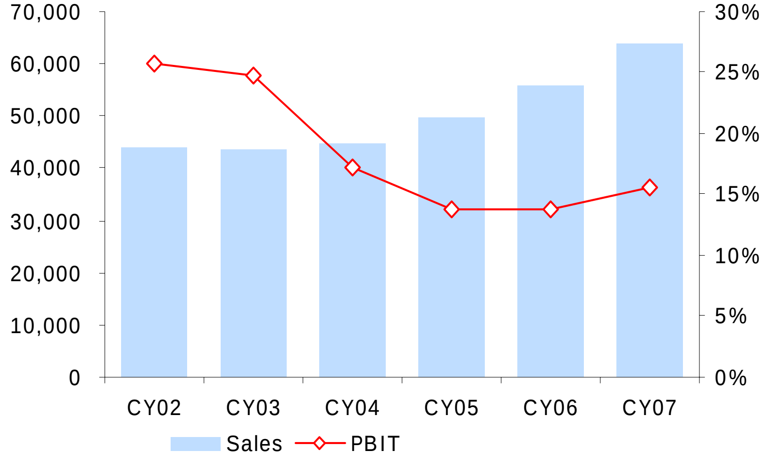
MF Global

Source: MF Global India Research Estimates

Growth in high-penetration categories (Soaps and Detergents) comes as a positive

- During the last four years (CY04-CY07), soaps and detergents, despite the highest penetration levels have been the key contributors to sales growth (about 49.5% of total growth in sales), recording growth of 12.6% CAGR against a marginal growth of 2.3% CAGR during CY01-CY04. This has led to an increase in its contribution to sales from 41.5% in CY04 to 45.8% in CY07.
- PBIT margins, during the period, however, were adversely impacted by competitive pricing pressure in detergents and a rise in input cost pressure initially in detergents and then in soaps.
- However, with the pricing scenario improving in detergents, margins of detergents have improved and have, in turn, led to improvement of blended margins of soaps and detergents despite intense pressure on soaps margins from higher input prices.
- Going forward, we estimate that soap and detergent sales will grow by about 9.9% CAGR during CY07-CY09 and PBIT margins will improve by about 77bps in CY08 and 25bps in CY09, led by an improvement in detergent margins.

Sales & PBIT trend in Soaps & Detergents

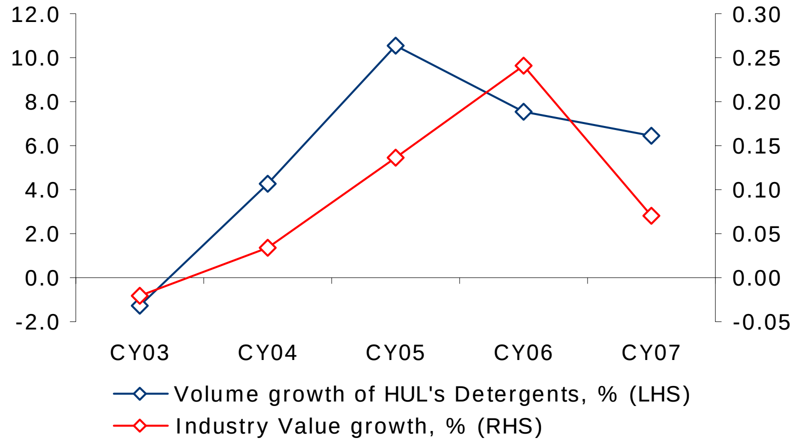


Source: MF Global India Research

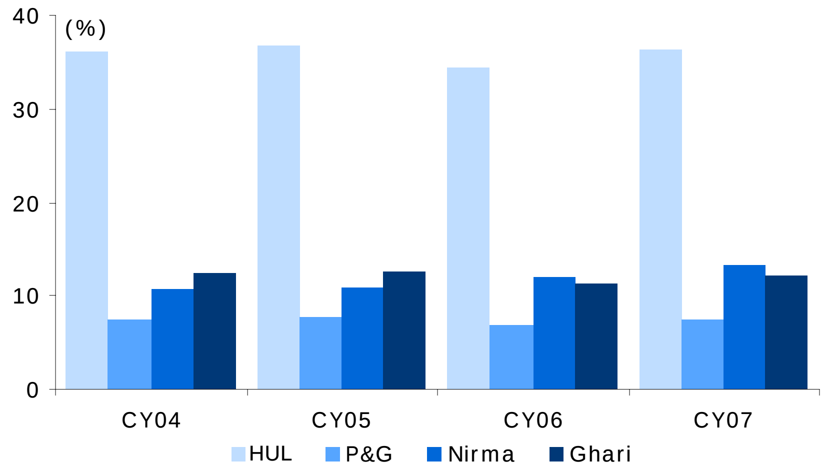
Detergent witnesses a revival post price war

- Detergents played a substantial role in the turnaround of the soaps and detergents division, growing at 15.9% CAGR during CY04-CY07 against a drop of 1.8% CAGR during CY01-CY04.
  - Volumes during CY04-CY07 grew by 9% CAGR with volume accelerating in the last four years.
  - Realisations grew during CY04-CY07 at 7.6% CAGR.
  - The division's contribution to HUL's business grew from 44% in CY04 to 48% in CY07.
- Revival in detergents was primarily due to:
  - Higher growth in the overall detergents category, triggered by price reductions and rising income levels.
  - Increase in HUL's market share, led by Surf and Wheel.
  - In the last two years particularly, realisation growth in detergents at 9.2% CAGR was higher over volume growth of 7% CAGR, reflecting the impact of both price hikes and improving product mix.

Volume growth in HUL's detergents & Value growth in Detergents Industry



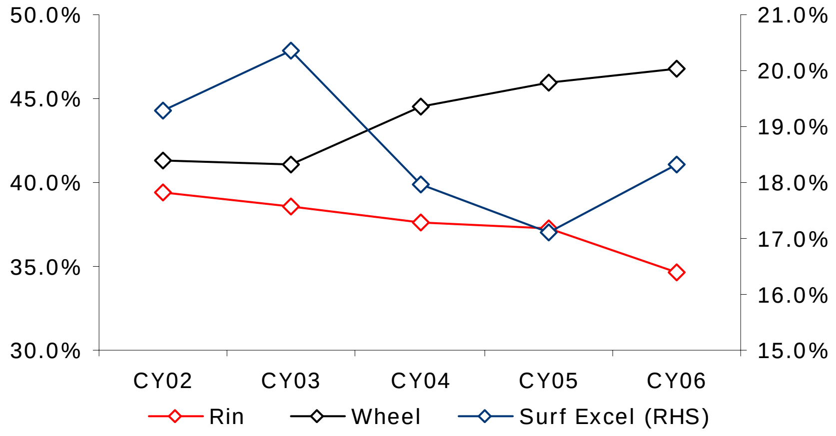
HUL's Market share in Detergents



Source: Industry, MF Global India Research

Richer mix and price hikes aid margins

Product mix of various brands in detergents (%)



Average Price Hike in various detergent brands (%)

Detergents	CY03	CY04	CY05	CY06	CY07	CY08
Surf/ Surf Blue	3.5	-15.6	5.3	0.0	0.0	0.0
Surf Excel /Quick Wash	-7.5	-27.5	6.3	4.0	1.1	5.0
Rin Shakti Powder	0.0	5.6	8.2	0.0	0.0	0.0
Rin Shakti	0.0	7.7	0.0	0.0	0.0	0.0
Wheel Powder Green	0.0	1.3	6.5	2.5	0.0	0.0
Wheel Bar Green	0.0	1.3	6.5	2.6	0.0	0.0

- We estimate that detergent profitability turned around from CY06, witnessing an estimated improvement of about 300bps. During CY07, profitability in detergents, witnessed a substantial improvement of about 557bps, aided by higher sales growth and price hikes (10-15%) in Surf and cost reduction across the supply chain.
- **We estimate Surf sales (18-20% of detergent sales) to have increased by about 45-47% CAGR in CY05-CY07.**
- Amongst HUL's three flagship brands, Surf (Premium), Rin (Popular) and Wheel (Economy), Surf is estimated to form more than 50% of detergent profits.
- Surf had witnessed price reductions to the tune of about 25% during CY04, which together with input cost pressure from LAB and Soda Ash (55% of detergent sales) had substantially dented margins of detergents, leading to a steep fall in PBIT margins of soaps and detergents by about 750bps.
- This substantial reduction in margins of soaps and detergents occurred despite the drop in palm oil prices (key raw material for soaps) during CY04 and consequent expected improvement in soap profits.

Source: MF Global India Research

Detergents to grow at 13.2%, margin to improve by 510bps

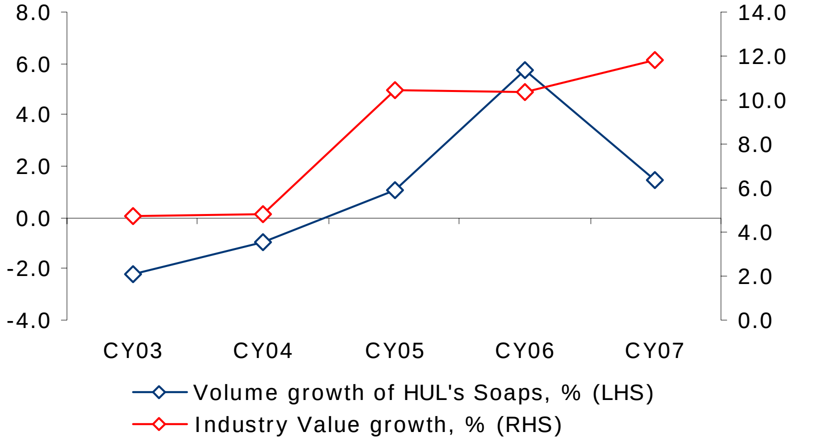
- Going forward, we estimate detergent sales to grow at 13.2% CAGR during CY07-CY09, led by higher growth in Surf.

- **Detergent margins are expected to improve by about 330bps during CY08 and by 213bps in CY09 with further price hikes in detergents (primarily in Surf).**

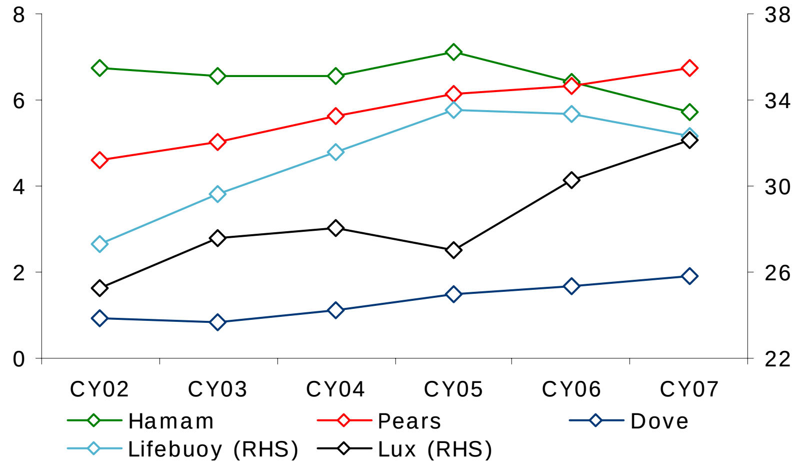
Soaps grow with better product mix

- HUL's soap sales have grown at a higher rate of 8.5% CAGR during CY04 to CY07 against a 4.5% CAGR during CY01-CY04.
- Volume growth during CY04-CY07 in soaps has improved by recording a 2.7% CAGR against a decline of about 1.4% CAGR during CY01-CY04 on the back of a better growth in the category.
- Volume growth in soaps would have been better sans the price hikes, which slowed the volume growth to 1.5% during CY07. During CY04-CY06, volume growth in soaps was higher at 3.4% CAGR.
- In addition, the company has witnessed an improvement in product mix with higher growth in Lux, Dove and Pears, which represent the premium and popular segment.
- The key factor in HUL's soap performance has been the success of Lux backed by the launch of variants and higher brand investments during the last 3 years.

Volume Growth in Soaps & Value growth in Soaps industry (%)



Product mix of various brands in soaps (%)



MF Global

Source: MF Global India Research

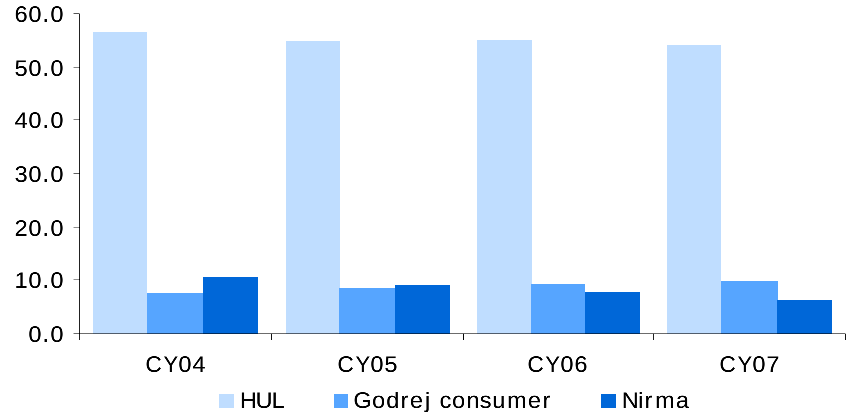
Rise in palm oil prices impacts margins

Hindustan Unilever

Average Price Hike in various soaps brands (%)

Brand	CY03	CY04	CY05	CY06	CY07
Lux	6.43	4	0	1.9	7.7
Lifebuoy	3.1	0.8	0	5.1	0
Breeze	0	3.2	2.3	0	0
Hamam	9.9	0.7	-1	2.4	7.3
Rexona	9.9	2.7	-1	2	4.9
Liril	1.5	0	0	0	8.8
Pears	0	0	0.3	2.9	0

HUL's market Share in Soaps (%)



- Lux has gained market share to the tune of 60-70bps, thus containing the drop in HUL's market share in soaps at about 55% against 57% in CY04.
- The company has mainly lost market share in the economy segment to Godrej Consumer (GCPL).
- **We estimate soap margins to have dropped by about 376bps during CY04-CY07, primarily due to the increase in crude palm prices affecting the prices of its derivatives, palm stearin, the key raw material for soaps and higher brand investments.**
- Price increases to tune of 5-8% across brands during the last two years and rising market share of Lux has, to an extent, offset the impact of rising palm stearin prices.

MF Global

Source: Industry, MF Global India Research

Soaps to grow at 9%, margins to decline by 296bps

- Going forward, we believe that soaps would grow by 5.7% CAGR during CY07-CY09, primarily backed by continued price increases and better growth in Lux.

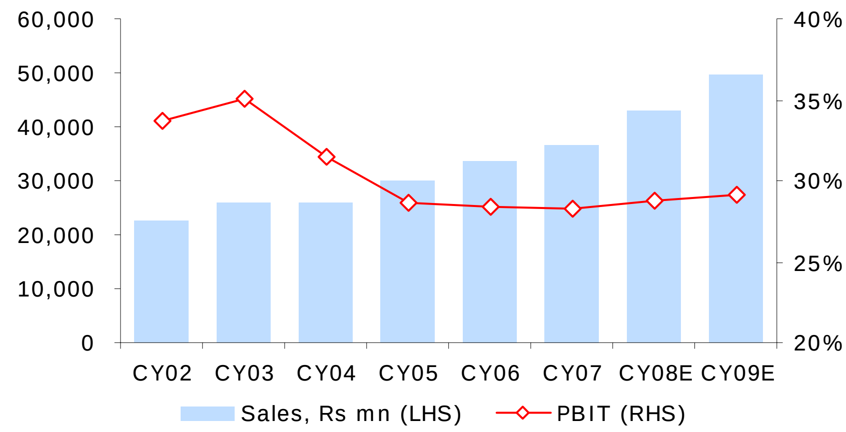
- We expect soap volumes to drop by 1.3% CAGR during CY07-CY09.

- Margins in soaps would, however, continue to drop by an estimated 151bps in CY08 and by 148bps in CY09 with pressure from rising palm stearin prices.

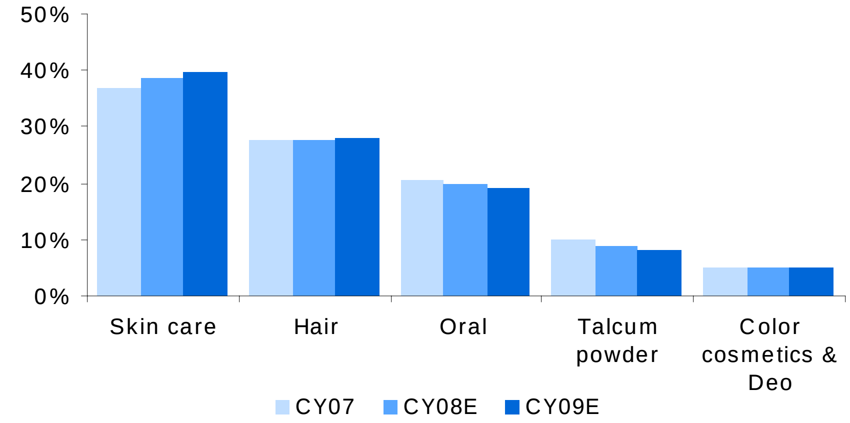
Personal products to better its performance, to grow at 16.4%

- Considering its low penetration levels, the personal products business has actually underperformed during CY04-CY07 by recording 14.1% CAGR in sales.
- The underperformance was more pronounced during CY05-CY07 with growth of about 11.5% CAGR.
- This could be primarily attributed to the slower growth in oral care (19-20% of sales) and skin care (35-37%) of sales.
- In oral care, HUL's market share dropped to 29.4% from 32.3%, while in the case of skin care, market share dropped to 54.6% from 59%.
- However, with renewed focus and brand spends in these two categories, coupled with growth in shampoos, this division is expected to witness a revival in the coming years.
- **We estimate personal products to grow by 16.4% CAGR during CY07-CY09.**

Sales & PBIT trend in Personal Products



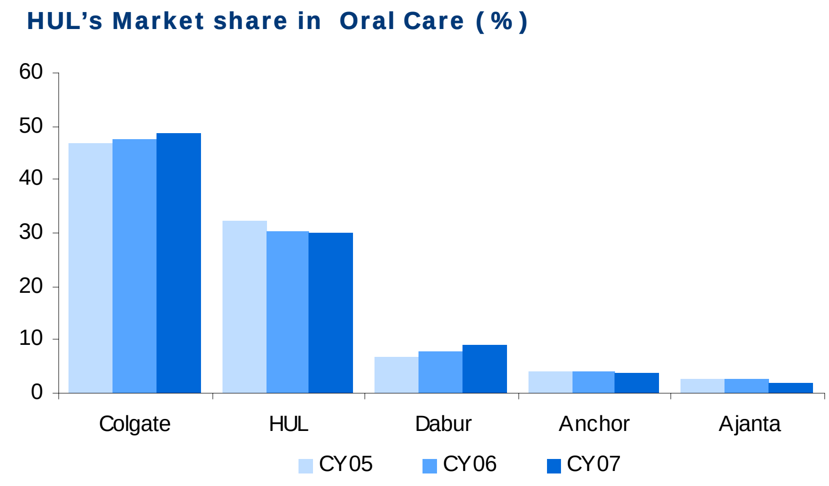
Expected mix within Personal Care Products

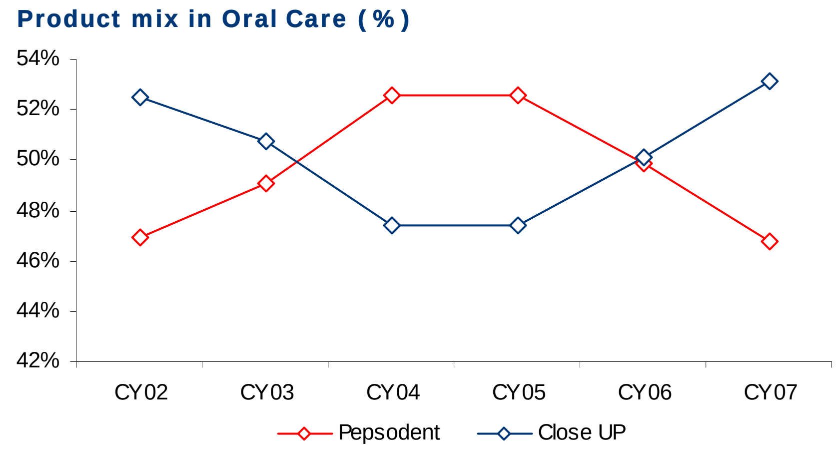


Source: MF Global India Research Estimates

Oral care to grow at 12.5%, led by renewed focus

- In oral care, HUL's market share dropped to 29.4% during CY07 from 32.3% in CY04 with a decline in market share in the popular segment (Pepsodent brand), primarily in favour of Colgate's new launch–Colgate Active Salt and Dabur's toothpaste portfolio.
- Colgate and Dabur have grabbed market share with high marketing efforts and increase in distribution network.
- HUL, on the other hand, lacked aggression in this category and also lacks a product in the economy segment. It taps the buoyant rural market only through small unit packs.
- HUL has renewed focus on the toothpaste category and is intensifying its marketing efforts to gain lost ground in the popular segment.
- Therefore, going forward, we could see more marketing initiatives from HUL and the company may also use its strong presence in modern retail to fuel growth in toothpastes.
- We expect HUL to launch more variants under Pepsodent in the coming quarters and regain market share. **We expect HUL's oral care business to grow at 12.5% CAGR during CY07-CY09.**



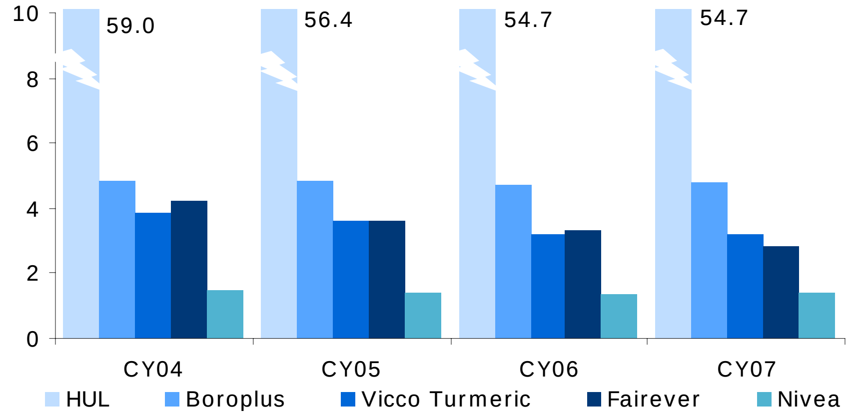


Source: Industry, MF Global India Research

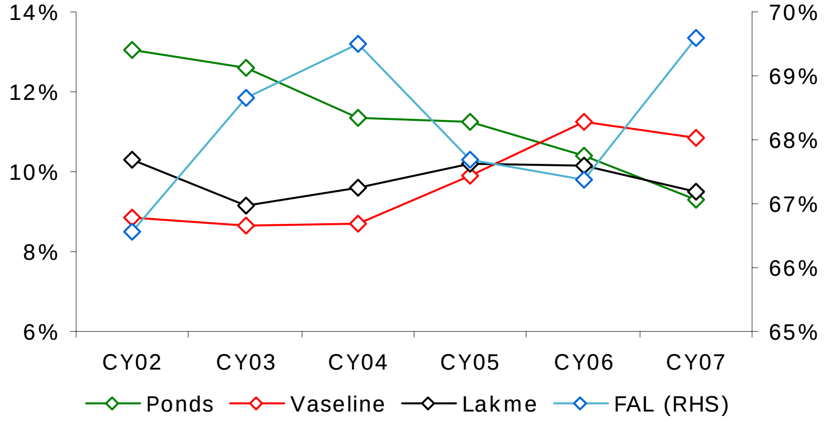
Skin care to grow by 20.5%, backed by product revamp

- In the skin care category, HUL's lack of product innovation and brand investments in its key brand FAL (Fair and Lovely) and Ponds, led to a subdued growth.
- Resultantly, the company lost market share in skin creams from about 59-60% in CY04 to 55% in CY06.
- During Q2CY07, HUL re-launched the entire portfolio of Fair and Lovely, backed by higher brand spends, which led to recovery in its market share. This is an important development as the brand is estimated to contribute about 50% of HUL's skin care sales.
- In addition, HUL ramped up brand spends in Ponds and launched anti-ageing and skin lightening products under the brand to tap the premium segment.
- Going forward, we believe that with higher brand investments in FAL and the newly launched Ponds portfolio, HUL is expected to outperform the skin care category.
- **We estimate HUL's skin care business to grow at 20.5% CAGR during CY07-CY09.**

HUL's Market Share in Skin Creams(%)



Product mix in Skin creams



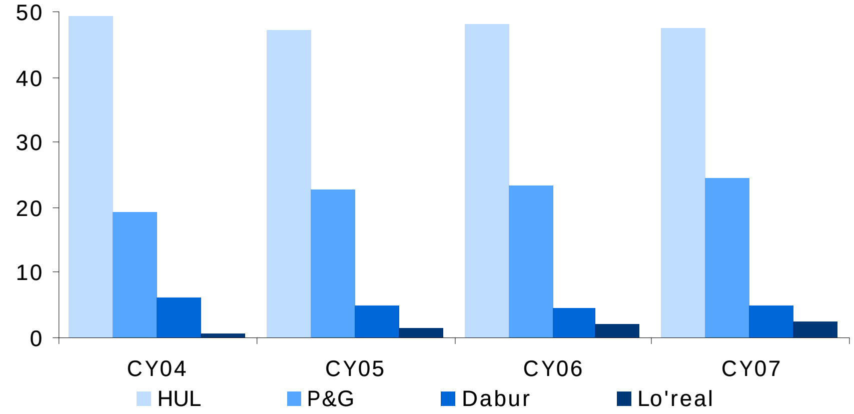
MF Global

Source: Industry, MF Global India Research

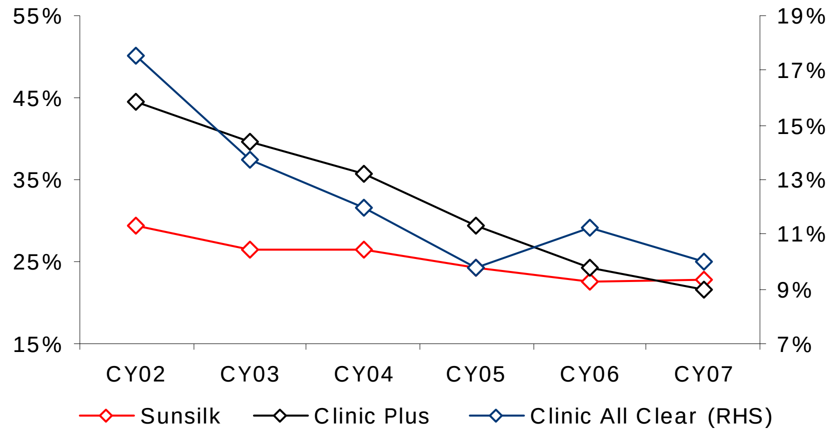
Shampoos to grow at 17.5%, aided by Dove and revival in the anti-dandruff segment

- In the hair care category, mainly represented by shampoos, the company has underperformed the industry primarily due to loss in market share in the anti-dandruff segment (Clinic franchisee).
- However, it has created a niche positioning in the premium daily care segment by the launch of Dove range of shampoos and conditioners during Q2CY07.
- Dove is estimated to have already gained about 2% market share in the shampoo market.
- Going forward, we believe that HUL will be able to outperform the shampoo category growth through better growth in the anti-dandruff segment and ramp up in operations in the premium daily care segment.
- The expected improvement in its anti-dandruff performance will be on the back of brand re-launches in both the premium brand Clinic All Clear and economy brand, Clinic Plus during the end of CY07. HUL introduced an offering for Men under the Clinic All Clear brand.
- **We estimate the shampoos segment to grow by about 17.5% CAGR during CY07-CY09.**

HUL's Market Share in Shampoos (%)



Product mix of various brands in Shampoos (%)



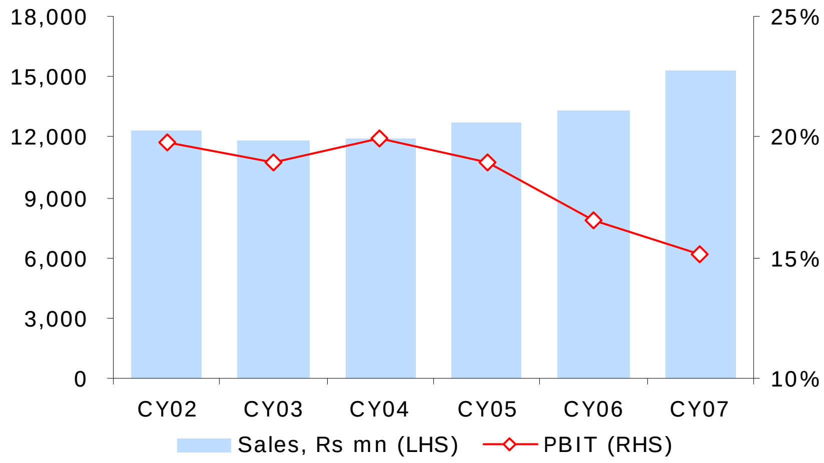
Source: Industry, MF Global India Research

Instant Coffee drives beverages growth, Tea on the backseat

Hindustan Unilever

- In beverages, HUL has grown at 8.7% CAGR during CY04-CY07, primarily led by about 12.5% CAGR in coffee.
- The performance in coffee has been backed by higher growth in instant coffee (Bru-Instant) with market share gains to the tune of 400bps at 45.4%.
- Branded tea, however, has grown at a slower rate of 4.8% CAGR during CY04-CY07 due to the lacklustre growth in the sector initially and lack of brand investments in its key brands-Brooke Bond Taj Mahal and Brooke Bond Taaza-in the premium and economy segment, respectively.
- Excluding CY07 growth, branded tea has actually grown at 2.3% CAGR during CY04-CY06.
- HUL's closest competitor, Tata Tea, has gained market share in these two segments through Tata Tea Premium and Tata Tea Agni. In case of Tata Tea Agni, the market share gains was due to reduction in prices during September 2007, making the product available at a discount over HUL's Taaza.

Sales and PBIT Trend in Beverages



MF Global

Source: MF Global India Research

Renewed focus across Tea brands to improve performance

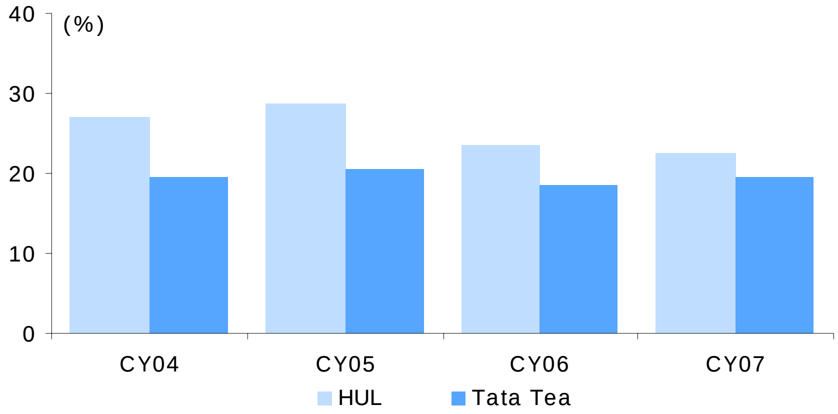
- HUL has taken consideration of its drop in market share in branded tea and revived its focus on the business with higher brand investments, particularly, in Taj Mahal from CY06. This, in turn, has contained the fall in market share in Taj Mahal during CY07.

- Further, we believe that, the company would be taking the following initiatives to improve Taaza's performance:
  - Eliminate pricing discount between Taaza and Agni by reducing prices of Taaza.
  - Ramp up investments on the brand.

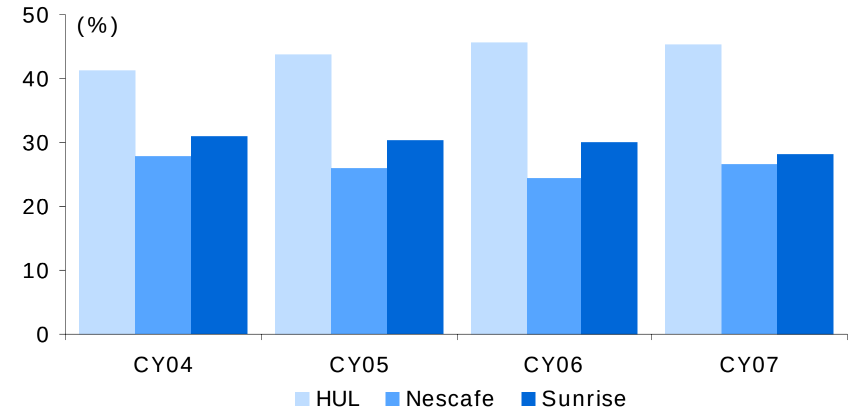
- Apart from the given two brands, HUL's popular segment brand, Red Label, has witnessed market share gains on the back of the launch of variants and small unit packs.

- Backed by expected better growth in Taj Mahal and Taaza and with continued growth in instant coffee, we expect beverages to grow by 11.4% CAGR, led by about 6.6% CAGR in Tea and 11.0% CAGR in Coffee during CY07-CY09.

HUL's Market share in Tea

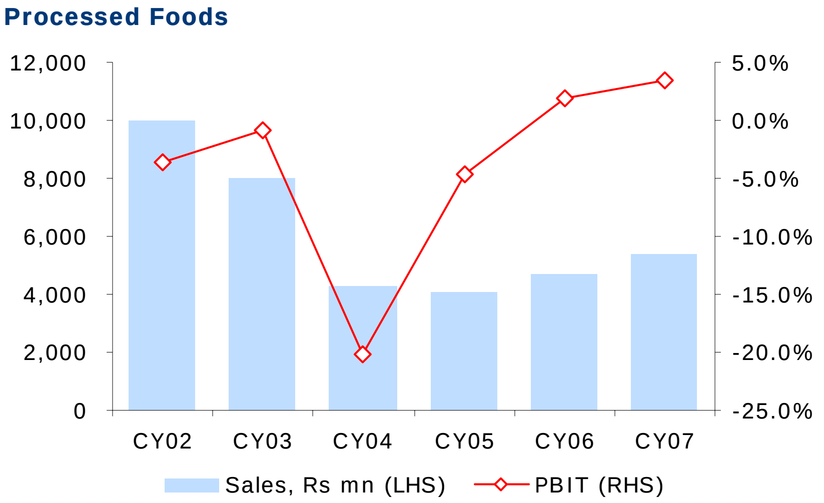


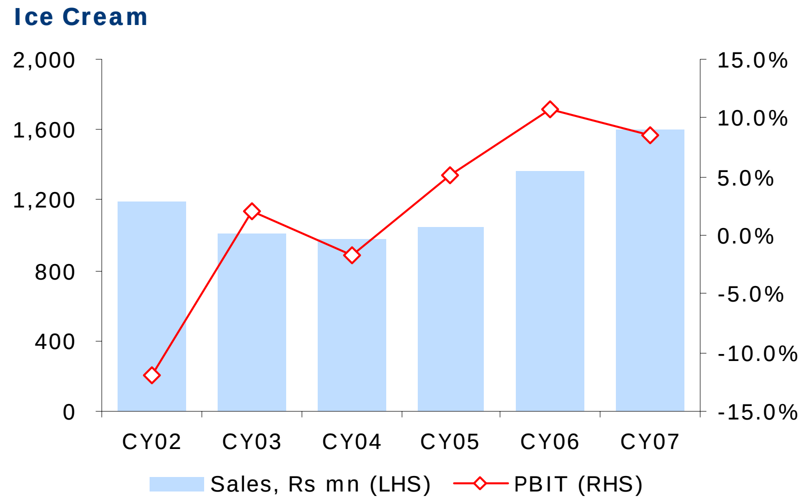
HUL's Market share in Coffee



Source: Industry, MF Global India Research

Ramp up in operations aid growth in Processed foods and Ice creams





- Processed foods has been one of the star performers for HUL during CY04-CY07, recording growth of 23.6% CAGR. Ice creams, during the period, has grown by 21.8% CAGR.
- Particularly in the last two years, CY05-CY07, processed foods has grown at a strong rate of 30.9% CAGR. This was led by the re-launch of products under the Kissan and Knorr brands and ramp up of operations.
- The company also worked on shortening of the inventory days, building in freshness in the stock.
- The ramp up in operations of processed foods, coupled with cost reductions in supply chain, led to better profitability for the business.
- Ice creams, in the last two years, has grown at 27.9% CAGR, led by new innovative product introductions, launch of small unit packs and increased distribution.

Source: MF Global India Research

Hugely untapped market and increased distribution to aid growth in processed foods and ice creams

- HUL will use its global experience and product portfolio to capitalise on the huge opportunity in packaged foods, which, currently, is valued at about US$ 14bn and is just 5% of the total foods market.

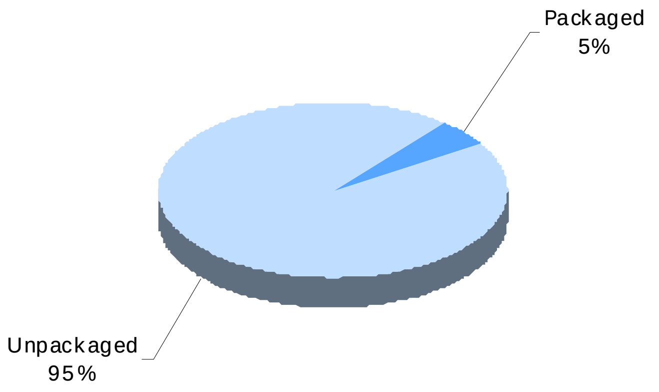
- **Working on introducing new products in the processed foods business, HUL has launched, Amaze, a range of brain food.**

- **We are not really enthused by the product range in view of the strong competition from GSK consumers and Heinz health beverage brands like Horlicks and Complan.**

- According to reports, led by higher disposable incomes, packaged foods is expected to grow by about 15-20% CAGR in the next five years.

- We believe that HUL will be able to grow processed foods and ice creams at 24% CAGR and at 8.2 % CAGR through further ramp up of operations and higher brand investments.

Share of Packaged Food in total food market (%)



Source: Company, MF Global India Research

Pureit to grow gradually

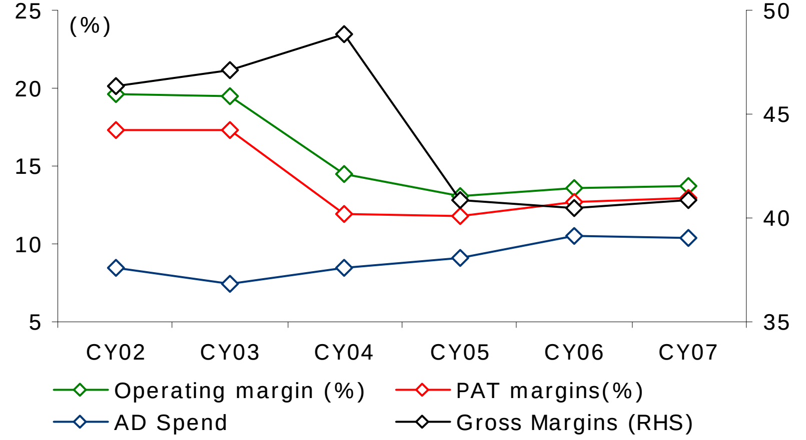
- HUL launched Pure-it, a cost effective drinking water purifier, across Karnataka, Andhra Pradesh, Kerala, Maharashtra, West Bengal and Delhi during CY07. It had earlier, test marketed the product in Tamil Nadu during the last two years.
- HUL is currently ramping up the distribution of Pure it across India and plans to complete the roll out by the end of CY08.
- We believe that the product would witness a gradual growth in sales in the coming years with water borne diseases being a key concern for Indian households due to shortage of pure drinking water.
- The product is expected to witness growth due to its affordability and cheaper pricing over other water-purifying systems.
- However, going forward, we also expect to see competition from other providers of water purifying systems.

Favourable pricing scenario and improving product mix to lead to better profitability

Hindustan Unilever

- HUL has witnessed about 70bps improvement in operating margins to 13.75% during CY05-CY07 despite the steep rise in prices of its key raw material, palm stearin, and continued buoyancy in prices of LAB and soda ash.
- In CY03-05, HUL's operating margins had dropped by about 645bps to 13%, primarily due to price reductions and rising input cost.
- The improvement in operating margins has been primarily led by an improvement in gross margins during CY05-CY07 by about 242bps to 46.7%, against a 358bps drop to 44.3% during CY03-CY05.
- Better gross margins have helped the company to invest in brand spends and renew its key businesses-soaps and detergents, personal products and beverages. Resultantly, ad-spends during CY05-07 have increased by 111bps to 10.2% of net sales.

Trend in margins and Ad spend (%)

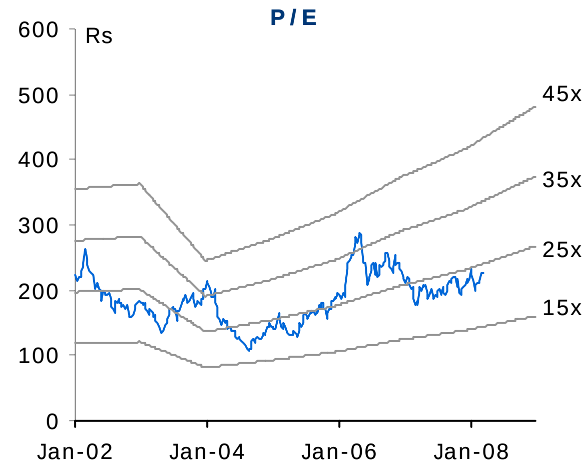


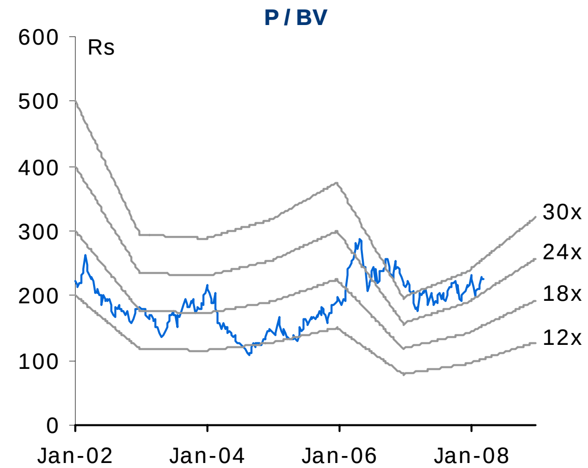
Source: *MF Global India Research*

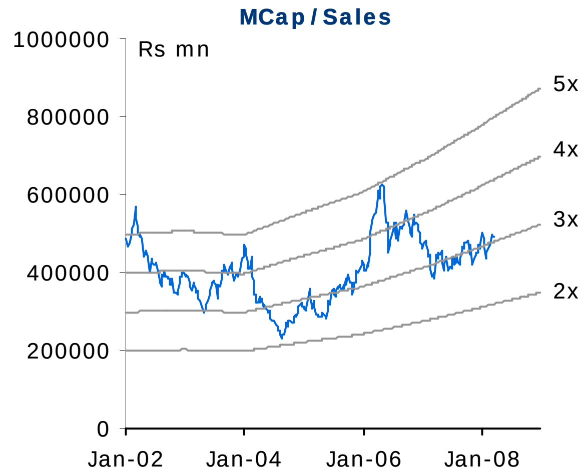
Outlook and Valuation

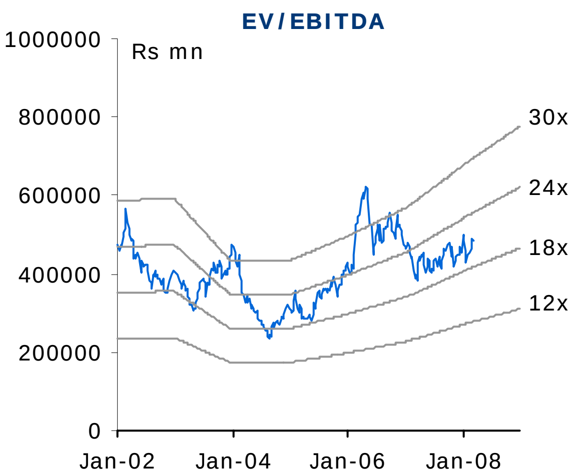
- Going forward, we estimate sales to grow by 12.4% CAGR to Rs 173.2bn, led primarily by higher growth in personal products and beverages.
- Operating margins are estimated to improve by 137bps to 15.1% during CY07-CY09, led by better margins in detergents and higher growth in personal products.
- We estimate PAT for HUL to grow by 15.4% CAGR to Rs 23.5bn during CY07-CY09.
- During the last six years, CY02-CY07, HUL has been valued at an average one-year forward PE of 25.5x.
- During the period of competitive pricing, CY02-CY05, the stock has traded at an average one-year forward PE of 24.8x. During CY07, due to concerns over rising palm oil prices impacting margins, the stock traded at its six-year low forward PE of 23x.
- However, with signs of renewal in personal products and a pick-up in growth and improvement in profitability of detergents, we believe that the stock is due to be re-rated despite the continued threat from rising palm oil prices.
- We, therefore, believe that the stock would trade at a one-year forward PE of 24.8x and by applying the same, we arrive at a stock price of Rs 268.

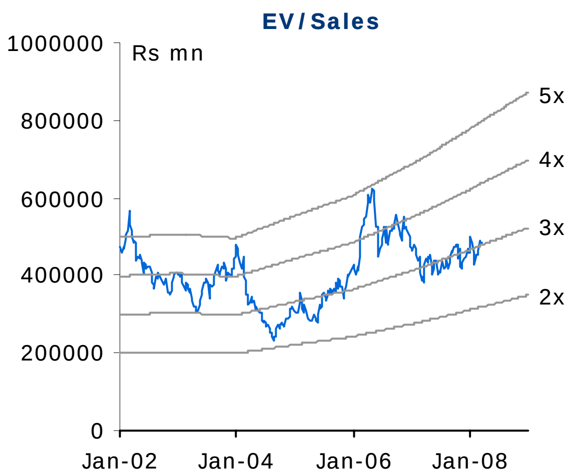
Absolute rolling Valuation band charts







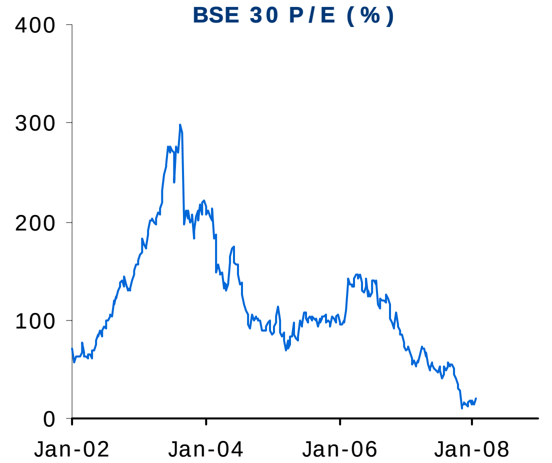


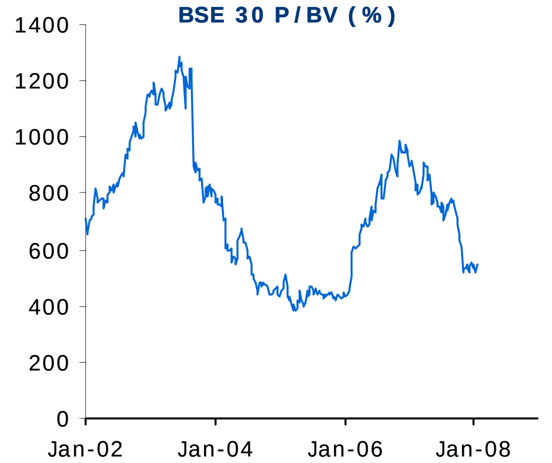


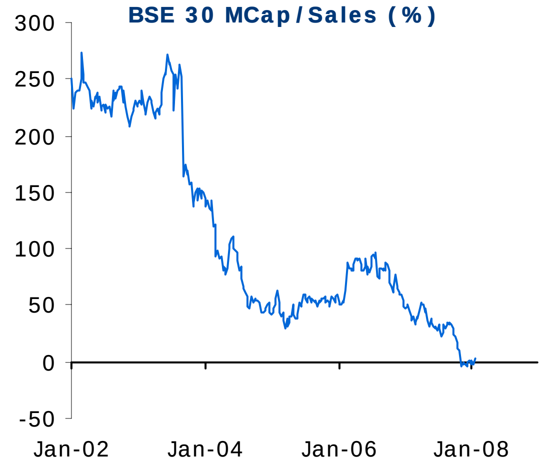
- Valuation multiples witnessed an improvement during CY06 with improvement in the product pricing scenario for the sector.
- However, during CY07, valuations were impacted by the personal products slowdown.
- During CY08, stock is due to be re-rated with improving scenario in the personal products segment and expected increase in detergents margins.

Source: MF Global India Research

Premium discount to Sensex







- HUL's de-rating during the detergent price war era of CY02-CY04 and threats from rising input cost, led to a reduction in its premium over the benchmark index.
- In addition, concerns over a slowdown in the most profitable division, personal products, took its toll on HUL's premium over the Sensex.
- We believe that with the pricing scenario improving and expected revival in personal products, HUL is due to be re-rated, leading to an increase in its premium over the benchmark index.

Source: MF Global India Research

Key risks

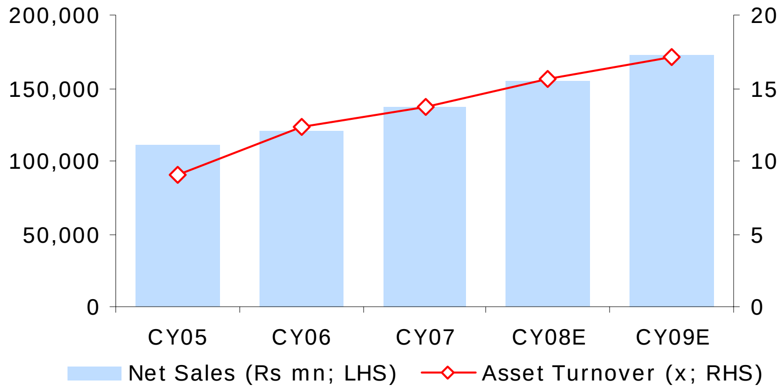
Risk	Our Comments
Sharp growth in LAB and Soda Ash prices arising from a sharp rise in crude oil prices.	Could put intense pressure on detergent margins and the need to take sharp price hikes.
Continued sharp growth in palm stearin prices.	Could lead to further price hikes in soaps and impact volumes
With global players like Nivea increasing their focus on India.	Competition in skin care may intensify.
ITC's foray in the personal care segment.	May increase competition in the medium to long term and may require higher ad-spends by HUL.

Key assumptions

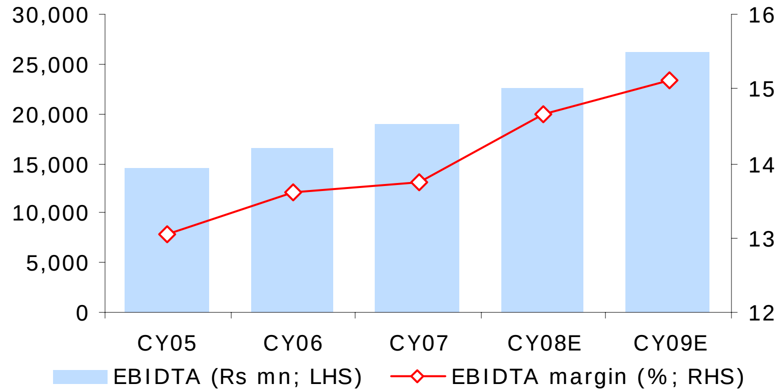
	CY08E	CY09E
Sales (Rs mn)		
- Soaps and Detergents	70,329	77,004
- Personal Products	42,898	49,774
- Beverages	17,265	19,020
- Processed Foods	6,807	8,262
- Ice Creams	1,739	1,879
- Exports	14,198	15,513
- Others (includes Chemicals, Plantations etc)	3,521	4,354
Cost (as % of net sales)		
Raw Material	52.4%	51.6%
Ad Spend	10.4%	10.6%
PBIT (Rs mn)		
- Soaps and Detergents	11,534	12,898
- Personal Products	12,355	14,484
- Beverages	2,607	2,872
- Processed Foods	259	339
- Ice Creams	157	188
- Exports	497	621
- Others (includes Chemicals, Plantations etc)	-528	-435
PBIT Margins (%)		
- Soaps and Detergents	16.4%	16.8%
- Personal Products	28.8%	29.1%
- Beverages	15.1%	15.1%
- Processed Foods	3.8%	4.1%
- Ice Creams	9.0%	10.0%
- Exports	3.5%	4.0%
- Others (includes Chemicals, Plantations etc)	-15.0%	-10.0%

Source: MF Global India Research Estimates

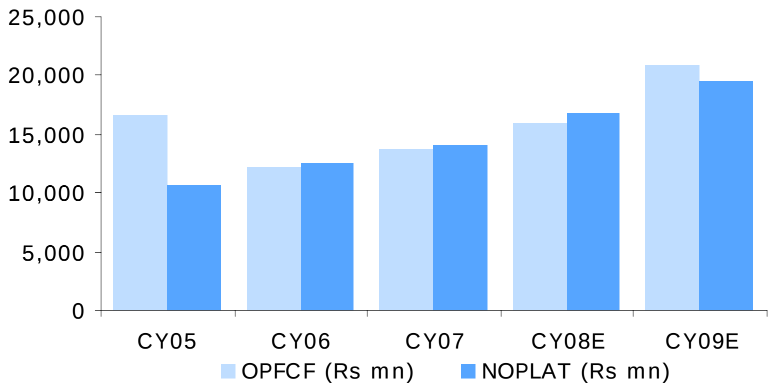
Financial Performance



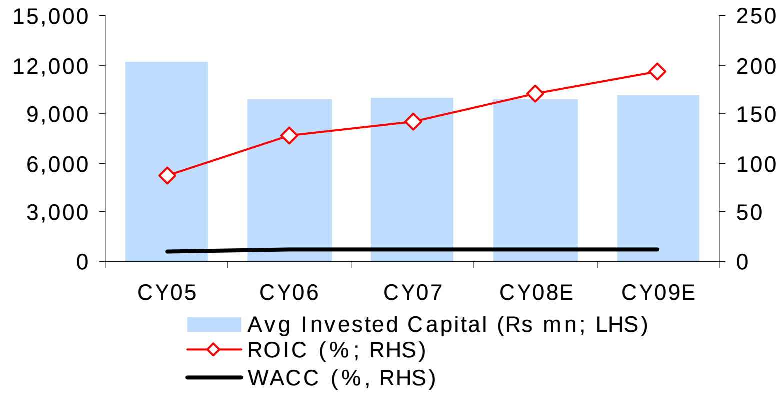
- Net sales is expected to grow at a CAGR of 13.1%, aided by better growth in personal products.



- EBIDTA to exceed sales growth with higher growth in personal products and improving detergent margins.



- Free cash flow generation to remain strong, assuring high dividend payout.



- Return ratios to improve with higher asset turnover and better profitability.

Source: MF Global India Research Estimates

Financials

Income Statement

Y/E Dec, Rs mn	CY05	CY06	CY07	CY08E	CY09E
Net sales	**110,605**	**121,034**	**137,178**	**154,541**	**173,158**
Growth, %	*11.4*	*9.4*	*13.3*	*12.7*	*12.0*
Total income	110,605	121,034	137,178	154,541	173,158
Operating expenses	-96,172	-104,553	-118,321	-131,908	-146,991
EBITDA	**14,433**	**16,481**	**18,857**	**22,633**	**26,167**
Growth, %	*0.4*	*14.2*	*14.4*	*20.0*	*15.6*
Margin, %	*13.0*	*13.6*	*13.7*	*14.6*	*15.1*
Depreciation	-1,245	-1,302	-1,384	-1,463	-1,544
EBIT	**13,189**	**15,179**	**17,473**	**21,170**	**24,623**
Growth, %	*0.2*	*15.1*	*15.1*	*21.2*	*16.3*
Margin, %	*11.9*	*12.5*	*12.7*	*13.7*	*14.2*
Interest received/(paid)	-192	-107	-255	-255	-255
Other Income	3,048	3,545	4,627	4,676	5,141
Pre-tax profit	**16,045**	**18,617**	**21,845**	**25,592**	**29,509**
Tax provided	-2,940	-3,218	-4,171	-5,190	-5,984
PAT before MI	**13,105**	**15,399**	**17,674**	**20,402**	**23,524**
PAT after MI & EOI	**14,081**	**18,554**	**19,255**	**20,402**	**23,524**
MF Global Net profit	**13,447**	**15,399**	**18,148**	**20,402**	**23,524**
Growth, %	*13.1*	*14.5*	*17.9*	*12.4*	*15.3*
EOI: Gains/(Losses)	976	3,155	1,581	0	0
Unadj. shares (m)	2,207	2,207	2,177	2,178	2,178
Wtd avg shares (m)	2,177	2,177	2,177	2,178	2,178

Balance Sheet

Y/E Dec, Rs mn	CY05	CY06	CY07	CY08E	CY09E
Cash & bank	3,550	4,169	2,009	2,863	7,411
Debtors	5,228	4,404	4,434	4,869	5,456
Inventory	13,218	15,477	19,536	22,017	24,669
Loans & advances	5,734	7,646	6,796	6,796	6,796
Total current assets	27,730	31,697	32,774	36,545	44,331
Investments	20,142	24,139	14,408	16,408	18,408
Gross fixed assets	23,633	24,509	26,691	27,691	29,691
Less: Depreciation	9,896	10,619	11,466	12,929	14,472
Add: Capital WIP	980	1,103	1,856	1,103	1,103
Net fixed assets	14,717	14,992	17,081	15,865	16,321
Non-current assets	3,505	3,972	4,037	4,037	4,037
Total assets	**66,094**	**74,800**	**68,301**	**72,855**	**83,098**
Current liabilities	29,695	32,016	38,371	39,289	43,215
Total current liabilities	29,695	32,016	38,371	39,289	43,215
Non-current liabilities	13,343	15,549	15,537	16,604	18,662
Total liabilities	43,038	47,565	53,908	55,893	61,877
Paid-up capital	2,201	2,207	2,177	2,178	2,178
Reserves & surplus	20,855	25,028	12,215	14,784	19,043
Shareholders' equity	23,056	27,235	14,392	16,961	21,220
Total equity & liabilities	**66,094**	**74,800**	**68,301**	**72,855**	**83,098**

Source: MF Global India Research Estimates

Financials

Hindustan Unilever

Cash Flow

Y/E Dec, Rs mn	CY05	CY06	CY07	CY08E	CY09E
Pre-tax profit	16,045	18,617	21,845	25,592	29,509
Depreciation	985	723	846	1,463	1,544
Chg in working capital	6,034	556	2,881	-931	2,332
Total tax paid	-2,940	-3,218	-4,171	-5,190	-5,571
Other operating activities	976	3,155	1,581	0	0
CF from opt. act.	**21,100**	**19,833**	**22,982**	**20,933**	**27,813**
Capital expenditure	-590	-998	-2,943	-246	-2,000
Chg in investments	2,154	-3,997	9,731	-2,000	-2,000
CF from invest. Act.	**1,563**	**-4,995**	**6,789**	**-2,246**	**-4,000**
Free cash flow	22,664	14,838	29,771	18,687	23,813
Equity raised/(repaid)	0	6	-29	0	0
Debt raised/(repaid)	-14,142	157	159	0	0
Dividend (incl. tax)	-12,602	-15,104	-23,316	-24,365	-25,798
Other financing activities	651	723	-8,745	6,532	6,532
CF from finan. Act.	**-26,094**	**-14,218**	**-31,931**	**-17,833**	**-19,265**
Net chg in cash	-3,430	619	-2,160	854	4,548

Per-share data

Y/E Dec, Rs mn	CY05	CY06	CY07	CY08E	CY09E
MF Global EPS (Rs)	6.2	7.1	8.3	9.4	10.8
Growth, %	*13.1*	*14.5*	*17.9*	*12.4*	*15.3*
Book NAV/share (INR)	10.6	12.5	6.6	7.8	9.7
FDEPS (INR)	6.2	7.1	8.3	9.4	10.8
CEPS (INR)	7.0	9.1	9.5	10.0	11.5
CFPS (INR)	8.0	6.3	7.8	7.3	10.4
DPS (INR)	5.1	6.1	9.1	10.0	10.6

Ratios

Y/E Dec, Rs mn	CY05	CY06	CY07	CY08E	CY09E
Return on assets (%)	18.9	22.0	24.9	29.1	30.4
Return on equity (%)	61.1	61.2	87.2	130.1	123.2
ROIC (%)	88.0	127.4	141.5	171.0	193.5
RoIC/Cost of capital (x)	7.9	10.6	11.1	13.3	15.0
RoIC - Cost of capital (%)	76.9	115.4	128.7	158.2	180.7
ROCE (%)	31.3	39.1	49.1	64.8	64.5
Cost of capital (%)	11.2	12.1	12.8	12.8	12.9
RoCE - Cost of capital (%)	20.1	27.0	36.3	52.0	51.6
Total debt/Equity (%)	2.5	2.7	6.2	5.2	4.2
Net debt/Equity (%)	-12.9	-12.6	-7.8	-11.7	-30.8
Asset turnover (x)	9.0	12.3	13.7	15.7	17.1
Sales/Total assets (x)	1.6	1.7	1.9	2.2	2.2
Sales/Net FA (x)	7.4	8.1	8.6	9.4	10.8
Working capital/Sales (x)	-0.05	-0.04	-0.06	-0.04	-0.04
Fixed capital/Sales (x)	0.21	0.20	0.19	0.18	0.17
Receivable days	17.3	13.3	11.8	11.5	11.5
Inventory days	43.6	46.7	52.0	52.0	52.0
Payable days	112.7	111.8	118.4	108.7	107.3
Current ratio (x)	0.9	1.0	0.9	0.9	1.0
Quick ratio (x)	0.5	0.5	0.3	0.4	0.5
Interest cover (x)	68.7	141.3	68.5	83.0	96.6
Dividend cover (x)	1.2	1.2	0.9	0.9	1.0
PER (x)	37.1	32.4	27.5	24.4	21.2
PEG (x) - y-o-y growth	2.8	2.2	1.5	2.0	1.4
Price/Book (x)	21.6	18.3	34.6	29.4	23.5
Yield (%)	2.2	2.7	4.0	4.4	4.6
EV/Net sales (x)	4.5	4.1	3.6	3.2	2.8
EV/EBITDA (x)	34.3	30.0	26.4	21.9	18.8
EV/EBIT (x)	37.5	32.6	28.4	23.4	20.0
EV/NOPLAT (x)	46.0	39.4	35.2	29.4	25.0
EV/CE	13.6	11.6	16.6	14.8	12.3
EV/IC (x)	40.5	50.2	49.8	50.3	48.5

Source: MF Global India Research Estimates

INITIATING COVERAGE

March 31, 2008

ITC (ITC IN / ITC.BO)

Play on an emerging economy's pricing strength

BUY

CMP Rs 206
Tgt Rs 234 (+13%)

This note should be read for
- *Estimated price hikes in cigarettes in FY08 and expected price hikes in FY09 and impact of the same*
- *Changing mix of ITC's cigarettes portfolio and impact on profitability*
- *Improving gross margins of packaged foods*

Investment Rationale

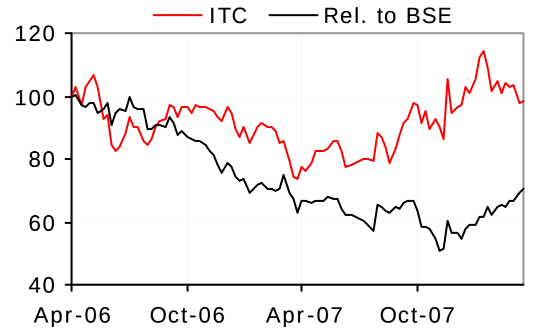
- Strong pricing power, backed by rising disposable income, aids volume growth in cigarettes despite sharp duty hikes and resultant price hikes.
- Sharp duty hike in non-filter cigarettes proposed by the Union Budget is expected to be a positive for the company in the long term due to its dominance in filter cigarettes.
- Other FMCG to witness consistent growth led by product introductions and further ramp up in operations. Packaged foods improving gross margins, to breakeven by FY09.
- Paper and hotels growth to be driven by capacity additions.
- Profitability of agri division to improve by 116bps in two years due to better mix.

Risks

- Sharp increase in excise duties on the filters segment after the substantial increase in non-filters during FY09.
- Delay in planned capacity additions in Paper and Hotels.
- Strong competition from global players in personal care.
- Prolonged ban on exports of agri-products.

Valuation

- The stock trades at a PE of 24.7x FY08E earnings and at 21.1x FY09E earnings and at an EV/EBIDTA of 17.0x FY08E earnings and at 14.0x FY09 earnings.
- Our sum-of-parts valuation gives us an intrinsic value of Rs 234 per share, providing an upside from 13% from the current levels.



Company data	
O/S shares :	3767mn
Market cap (Rs) :	777bn
Market cap (USD) :	19.4bn
52 - wk Hi/Lo (Rs) :	239 / 141
Avg. daily vol. (3mth) :	8.9mn
Face Value (Rs) :	1

Share holding pattern, %	
FII / NRI :	47.4
FI / MF :	37.6
Non Pro. Corp. Holdings :	2.4
Public & Others :	12.7
Total Govt :	0.02

Y/E Mar, Rs bn	FY07	FY08E	FY09E
Net Sales	123.7	140.6	165.5
PAT	27.0	31.4	36.7
EBIDTA mrg, %	32.0	31.5	31.8
PAT mrg, %	21.8	22.3	22.2
ROE, %	27.7	27.8	27.9
EPS, Rs	7.2	8.4	9.8
PER, x	28.7	24.7	21.1

Investment Overview

Sustainable competitive advantage	Domination in the Indian cigarettes industry with a major presence in filter cigarettes. Strong rural procurement and distribution in place through the Choupal network.
Financial structure	Low gearing due to strong free cash flows.
Shareholder value creation	Dividend payout improving over the years.
Earnings visibility	Strong pricing power and dominating presence in cigarettes gives us comfort on the overall growth in earnings.
Valuation	At the CMP of Rs 206, the stock is trading at PE and EV/EBIDTA of 21.1x and 14.0x FY09E earnings. We believe that the stock may underperform in the short term due to uncertainties over price hikes and the impact. However, the long-term story of rising disposable income levels favouring cigarettes growth remains intact and we therefore, believe that the stock will trade at a premium over its global peers.
MF Global vs. consensus	Our FY08 estimates are over consensus estimates and our FY09 estimates in line with consensus estimates.
Future event triggers	A sharp rise in duties on filter cigarettes could be a negative for the stock.

Valuation Summary

Y/E Mar, Rs mn	FY2006	FY2007	FY2008E	FY2009E	FY2010E
Net Sales	97,905	123,693	140,623	165,493	201,711
Growth, %	28.2	26.3	13.7	17.7	21.9
Core EBIDTA	33,274	39,564	44,232	52,597	61,991
EBIDTA margins, %	34.0	32.0	31.5	31.8	30.7
Net profit	22,804	27,000	31,413	36,686	43,591
Net profit margin, %	23.3	21.8	22.3	22.2	21.6
EPS, Rs	6.1	7.2	8.4	9.8	11.6
EPS Growth, %	3.1	18.4	16.3	16.8	18.8
PER, x	34.0	28.7	24.7	21.1	17.8
EV/EBIDTA, x	23.1	19.4	17.0	14.0	11.6
EV/Net Sales, x	7.8	6.2	5.3	4.5	3.6
Price/Book Value, x	8.6	7.4	6.4	5.5	4.7
ROIC, %	34.2	32.6	31.5	36.3	39.8
ROE, %	26.9	27.7	27.8	27.9	28.4
Dividend Yield, %	1.3	1.6	1.8	2.1	2.5

Source: MF Global India Research Estimates

Addictive pricing power in a resilient economy, aid volumes

Price Hikes and impact on volumes in FY08 (%)

Category	Volume mix	Price hike	Volume growth
King size	8.8	12.4	13.00
Mini King size	6.2	25.9	-20.00
Regular Filter	66.1	22.0	2.00
Plains	13.4	23.7	-14.00
Micros	5.6	11.1	-9.00

Impact of higher duties dropping with rising disposable income (%)

	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08
Growth in duty	5.0	15.0	0.0	0.0	0.0	10.0	5.0	18.5
Growth in ITC's cigarette volumes	0.5	-8.4	4.2	3.1	7.1	8.4	7.1	-1.0
Growth in disposable income	8.9	-35.0	80.0	11.3	7.1	13.0	7.0	–

ITC

- During FY08, despite the steep price hikes on cigarettes to the tune of 21%, ITC's cigarettes division is estimated to record a marginal volume drop of 1% as against earlier expectations of a 5-7% volume decline.
- This reflects the company's stronger pricing power in a scenario of rising disposable income.
- Product mix in cigarettes has improved with filters growing at an estimated 1% against an expected decline of 8% in non-filters.
- Volume drop in Plains and Mini Kingsize is believed to have increased during FY08 while Regular filter is estimated to have grown at a low pace of about 2-2.5% due to the loss of the Rs 2 price point, primarily in case of Gold Flake Filter and Premium (forming about 32-33% of total volumes).
- King size, being the most price inelastic segment has been un-impacted by the price hike and is estimated to have grown at an accelerated pace with up-trading.

Profit improving with price hikes and better product mix

- Profitability improving with price hikes
  - As stated earlier, price hikes during FY08 have led to a higher contribution of filter cigarettes to total volumes. This, in turn, has led to higher net realisations and profitability for the cigarettes division.
  - Higher net realisations lead to higher profitability for the division as the other key variable cost besides the duty on cigarettes is the raw material cost, which stands at a low 7% of cigarette sales. In addition, the scope for increase in marketing spends are limited due to a ban on advertising of cigarettes.

Growth in Net realisation and EBIDTA

Cigarettes	FY06	FY07	FY08E
Sales Value (Rs mn)	113,229	128,244	138,236
Sales Volume (mn sticks)	75,894	81,265	80,511
Gross Realisations per stick	1.49	1.58	1.72
Duty per stick (Rs)	0.81	0.85	0.92
Net Realisation per stick	0.68	0.72	0.80
Growth In net Realisation(%)	-	6.7	10.5
EBIDTA margins(%)	24.8	25.5	26.9

Higher net realisation lowering other expenditure

% of Net Sales	FY04	FY05	FY06	FY07	FY08E
Raw Material	6.2	6.4	7.1	6.7	7.2
Other Expenditure	20.6	16.8	13.7	13.7	12.86
EBIDTA margin	23.1	24.0	24.8	25.5	26.9

Source: MF Global India Research Estimates

Increase in non-filter cigarette duties positive in the long term

- Excise duties on non-filter cigarettes, plains and micros have been increased during the current budget substantially from Rs 546 and Rs 168 per 1000 sticks to Rs 1323 and Rs 819 per 1000 sticks.

- This is estimated to lead to an overall excise duty increase on ITC's portfolio to the tune of 16.3%. We estimate that ITC would be required to hike cigarette prices by about 6.5% to offset the increase in excise.

- Given that filter cigarettes contribute about 81% of ITC's volumes, this comes as a positive for the company in the long run as it would lead to increased contribution of filter cigarettes in the Indian cigarettes industry. Therefore, ITC's market share is effectively set to grow due to its strong dominance in the filters segment.

- Also with higher contribution by filters, the division's profitability is set to improve, going forward.

		Excise duty per stick	
Category	% of sales	FY08E	FY09E
King size	8.8%	1.76	1.76
Mini king size	6.2%	1.32	1.32
Regular filter	66.1%	0.82	0.82
Plains	13.4%	0.55	1.32
Micros	5.6%	0.17	0.82
Effective duty increase			**6.50**

Source: MF Global India Research

ITC may take price hikes on all segments with major focus on plains and micros (contd…)

- If the current Union Budget proposal is made final, we estimate prices to be hiked by about 15% on the total cigarette portfolio with major emphasis on Plains and Micros.

- We believe that despite being the most important segment, ITC may require to take price hikes on regular filters to the tune of 12.6%. This, we believe, would be primarily in case of Gold flake Filter and Gold Flake Premium, forming an estimated 32-33% of total cigarette volumes.

- We believe that Gold Flake has already witnessed the impact of losing the Rs 2 price point and going forward, we believe that the impact of a further 16-17% hike will not be a big concern.

- Our expected pricing structure for ITC during FY09 will essentially reduce the pricing premium between King size and Mini king size and Regular Filter and Plains, thus encouraging consumers to upgrade.

Average MRP, Rs/stick	FY07E	FY08E	FY09E
King size	3.44	3.86	4.14
Mini kingsize	2.70	3.40	3.8
Regular filter	1.75	2.13	2.38
Plains	1.24	1.53	2.15
Micros	0.45	0.50	1.25

Pricing Premium, %	FY07E	FY08E	FY09E
King size vs Mini kingsize	27.5	13.6	8.9
Mini kingsize v/s Regular Filter	54.2	59.3	59.4
Regular filter	41.1	39.1	10.9
Plains	175.7	206.9	71.9

Price hikes, %	FY08E	FY09E
King size	12.3	7.0
Mini kingsize	25.9	11.8
Regular filter	22.0	12.6
Plains	23.7	39.4
Micros	11.1	150.0

Source: MF Global India Research Estimates

ITC may take price hikes on all segments with major focus on plains and micros

		MRP per pack (Rs)			MRP per stick (Rs)		
Segment	Brands	FY07	FY08	FY09E	FY07	FY08	FY09E
King size	India Kings	90.0	100.0	110.0	4.5	5.0	5.5
King size	Benson and Hedges	80.0	90.0	100.0	4.0	4.5	5.0
King size	State express	80.0	90.0	100.0	4.0	4.5	5.0
King size	Classic	70.0	80.0	90.0	3.5	4.0	4.5
King size	Gold flake	34.0	38.0	40.0	3.4	3.8	4.0
Mini-kingsize	Wills Navy cut	27.0	34.0	38.0	2.7	3.4	3.8
Mini-kingsize	Wills Navy silk cut	27.0	34.0	38.0	2.7	3.4	3.8
Regular filter	Gold flake premium	20.0	24.0	28.0	2.0	2.4	2.8
Regular filter	Gold flake filter	20.0	24.0	28.0	2.0	2.4	2.8
Regular filter	Scissors filter	17.5	20.0	20.0	1.8	2.0	2.0
Regular filter	Scissors menthol	17.5	20.0	20.0	1.8	2.0	2.0
Regular filter	Wills flake premium	17.0	20.0	20.0	1.7	2.0	2.0
Regular filter	Wills flake filter	15.0	17.5	19.0	1.5	1.8	1.9
Regular filter	Berkeley filter	14.0	17.5	19.0	1.4	1.8	1.9
Regular filter	Bristol filter	14.0	19.0	19.0	1.4	1.9	1.9
Regular filter	Capstan Filter	14.0	19.0	24.0	1.4	1.9	2.4
Regular filter	Capstan Menthol	14.0	19.0	24.0	1.4	1.9	2.4
Regular filter	Bristol Menthol	14.0	19.0	19.0	1.4	1.9	1.9
Regular filter	Wills Silk cut	0.0	20.0	20.0	0.0	2.0	2.0
Plain	Gold flake plain	14.8	17.5	28.0	1.5	1.8	2.8
Plain	Scissors plain	12.0	15.0	20.0	1.2	1.5	2.0
Plain	Capstan Plain	10.0	12.5	17.5	1.0	1.3	1.8
Plain	Berkeley plain	10.0	12.5	17.5	1.0	1.3	1.8
Micros		4.5	5	12.5	0.5	0.5	1.3

Source: Industry, MF Global India Research Estimates

Volumes to drop 7.0% YoY, Plains and Micros to drop 45% and 60%

- We believe that due to our expected pricing action, the overall volumes of the filters segment would grow by 2.9% YoY and the non-filter volumes would decline by 49.4% YoY causing an overall drop in volumes of 7% YoY.

- With the substantial reduction in pricing premium between Plains and Regular filters, the portion of Plains consumers, who are actually dual consumers of tobacco and have been upgrading to filters, will continue to upgrade. However, we believe that a major portion of Plains consumers may reduce consumption and may switch to cheaper options of chewing tobacco like Gutkha, which is growing at a substantial pace.

- Micros are expected to be adversely hit and may witness a major decline of about 60% YoY in favour of Bidis and cheaper options of chewing tobacco.

	Volume impact		Product mix	
	FY08E	FY09E	FY08E	FY09E
King size	13%	12.0%	8.8%	10.6%
Mini kingsize	-20%	-22.0%	6.2%	5.2%
Regular filter	2%	4.0%	66.1%	73.9%
Filter	**1%**	**2.9%**	**81.0%**	**89.7%**
Plains	-14%	-45.0%	13.4%	7.9%
Micros	9%	-60.0%	5.6%	2.4%
Non Filter	**8.4%**	**49.4%**	**19.0%**	**10.3%**
Total Volumes	1%	-7.0%	100%	100%

Source: MF Global India Research Estimates

Profitability to improve with richer mix

- As has been witnessed in the past, EBIDTA margins of the cigarettes division are expected to improve with higher contribution of filter cigarettes.
- We, therefore, estimate EBIDTA margins of the cigarettes division to increase by about 270bps during FY09 and by about 126bps during FY10 to 29.6% and 30.8%, respectively, against 26.9% in FY08.
- We expect cigarette sales to grow by 7.9% CAGR to Rs 161.9bn during FY07-FY10, primarily led by realisation growth of 10.3%. We estimate volumes to drop by about 2.03% YoY during the given period.

Segment	FY08E	FY09E	FY10E
King size	9%	11%	12%
Mini kingsize	6%	5%	4%
Regular Filter	66%	74%	77%
Filters	81%	90%	93%
Plains	13%	8%	5%
Micros	6%	2%	1%
Non-filters	19%	10%	7%
Total	**100%**	**100%**	**100%**

Cigarettes Division, Rs mn	FY08E	FY09E	FY10E
Sales	138,497	149,472	161,883
EBIDTA	37,281	44,218	49,934
EBIDTA margin %	26.9%	29.6%	30.8%

Source: MF Global India Research Estimates

Cigarettes to be valued at a premium, Valued at Rs 164 per share

- In comparison with its global peers, we believe that ITC's cigarettes division would trade at a premium in view of:
  - Dominance in the Indian cigarette industry.
  - Low per capita consumption (set to rise with rising disposable income levels).
  - Zero litigation risk.

- We, therefore, assign a multiple of 20x to the cigarettes division arriving at a per share value of Rs 164 per share for FY09E.

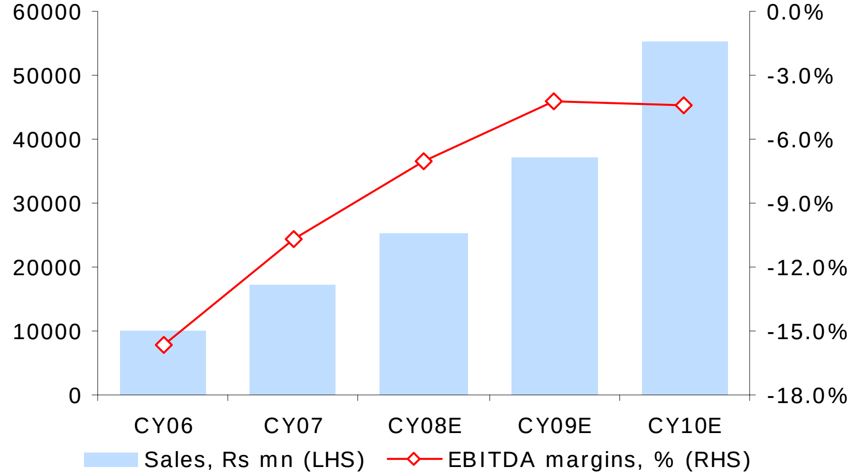
		BAT	Japan Tobacco	Swedish match	Souza Cruz	KT&G	Altria Group	Reynolds American	Rothmans Incorporation	Gudang Garam	UST	Imperial Tobacco	ITC
Sales, US$ mn	CY07	20,043	40,782	1,857	2,486	2,596	38,051	9,023	543	2,873	1,893	6,569	3,092
	CY08E	21,746	69,593	2,167	2,924	2,561	40,213	9,237	665	3,270	2,019	11,358	3,515
EBIDTA, US$ mn	CY07	6,680	3,973	-	701	1,022	14,651	2,496	255	310	943	3,110	989
	CY08E	7,540	6,659	558	864		15,922	2,669	338	361	986	4,401	1,106
PAT, US$ mn	CY07	4,261	1,802	304	465	386	9,786	1,308	88	110	520	1,812	675
	CY08E	4,785	2,233	350	595	718	10,078	1,430	113	186	559	2,346	785
EV/EBIDTA, x	CY07	13.5	10.1	–	11.5	10.8	11.2	8.6	4.7	8.7	9.9	14.1	16.5
	CY08E	11.2	6.0	0.0	9.2	–	10.0	7.4	3.6	5.4	9.5	9.3	13.6
EV/Sales, x	CY07	4.5	1.0	3.8	3.2	4.2	4.3	2.7	2.2	0.9	4.9	6.2	6.0
	CY08E	3.9	0.6	0.0	2.7	0.0	3.9	2.2	1.8	0.6	4.6	3.6	5.2
P/E,x	CY07	17.2	27.7	18.3	–	–	15.8	13.8	19.5	–	17.1	17.3	27.9
	CY08E	14.9	22.1	14.8	14.5	0.0	15.1	12.7	14.8	8.0	15.1	14.8	24.0

Source: Bloomberg

Other FMCG on the growth path, packaged foods ramp up in process

- Other FMCG (non-cigarette FMCG) has been primarily driven by the strong growth in packaged foods (accounting for 60.5% of other FMCG sales).
- Packaged foods has grown by 98.7% CAGR to Rs 10,710m during FY04-FY07. This has been led largely by strong growth in biscuits (40% of packaged foods) under the Sunfeast brand and branded Atta (30% of packaged foods) under the Ashirwad brand.
- In a span of four years, ITC has gained about 8-10% market share in biscuits and in a span of six years, market share in Atta has reached about 52%. This has been primarily aided by a strong procurement network (e-choupal).
- The fresh launch, Bingo, in the snacks category of packaged foods is expected to achieve about Rs 1bn value of sales during FY08. Going forward, the company plans to achieve about Rs 2bn value of sales during FY09.
- The packaged foods business is expected to grow at a CAGR of 50% to Rs 36,124m during FY07-FY10, primarily led by launches of variants and fresh launches. The strong growth expected in the Indian branded packaged foods market will also aid growth for ITC.

Other FMCG



Source: MF Global India Research Estimates

Packaged foods gross margins improving, to breakeven by FY09

- Packaged foods is expected to breakeven by the end of FY09 after the company achieves a strong Rs 2bn in Bingo and requires relatively lower brand spends in the business.
- Estimated gross margins in packaged foods have been consistently improving in the last four years, which is evident from the overall decline in raw material cost of the other FMCG division.
- Resultantly, despite high advertisement spends by the company, the packaged foods business is estimated to have witnessed a reduction in losses.
- According to the company, packaged foods excluding Bingo has already achieved breakeven.

Other FMCG (% of net Sales)

	FY04	FY05	FY06	FY07	FY08E
Raw Material	49.6	55.0	53.6	41.9	39.7
Other Expenditure	106.1	78.3	62.0	68.7	67.3

Source: MF Global India Research Estimates

Other FMCG (ex Packaged Foods) going strong

- Other FMCG (excluding packaged foods) has grown by 58% CAGR to Rs 6,983mn during FY04-FY07, primarily driven by lifestyle retailing, confectionaries and paper stationery business.

- Lifestyle retailing and confectionaries clocked sales of Rs 1.6bn during FY07, backed by a ramp-up in distribution from 1730 outlets in FY04 to 2070 outlets in FY07. The company plans to double its sales over the next 3-4 years through a ramp-up in distribution network. We, therefore, estimate the business to clock growth of about 25% per annum.

- Under confectionaries, the company has two brands, Minto Fresh and Candyman. Minto Fresh has garnered about 17% market share in the cough lozenge segment which is 10.3% of the Rs 16bn confectionary market.

- Under the paper stationery business, the company plans to ramp up operations in the next 2-3 years to achieve estimated sales of about Rs 5bn, from about Rs 1.5bn in FY07. It is adding capacity of about 100,000 tonnes during FY09 to boost paper stationery sales.

Personal care may take 5 years to break even

- ITC recently forayed in to the personal products category through the launch of soaps and shampoos. The company is tapping the premium category through Fiama Di Wills, while the popular category and sub-popular category would be tapped by Vivel Di Wills and Superia, respectively.

- ITC is in the process of ramping up operations through increased distribution across the country. In addition to its cigarettes distribution, the company already has the groceries channel created through its packaged foods foray to fall back on.

- We believe that the personal care foray would take about 5 years to establish a presence as it is pitched against global players like HUL and P&G in this category.

- Moreover, personal care, is a global category and global players have the advantage of strong global branding and consumer experience. However, we believe that soaps would be a category where the brand penetration would be faster as compared to shampoos as smaller FMCG players have been able to create a brand in this category.

Other FMCG to grow at 49.9% CAGR, valued at Rs 30 per share

- We expect other FMCG (excluding packaged foods) to grow at 49.8% CAGR during FY07-FY10, leading to a growth in total other FMCG of about 49.9% CAGR during FY07-FY10 to Rs 57,400mn.
- However, other FMCG is expected to continue to make losses in the near future due to the personal care foray, which requires high brand investments.
- **Therefore, we have valued the business on an EV/sales basis. We have assigned a multiple of 3x to the other FMCG business and arrive at a value of Rs 30 per share.**

	HUL	ITC	Marico	Dabur	Nestle	Britannia
	CY08E/FY09E	CY08E/FY09E	CY08E/FY09E	CY08E/FY09E	CY08E/FY09E	CY08E/FY09E
Sales, Rs mn	155,517	165,493	19,208	25,287	40,050	32,216
EBIDTA, Rs mn	22,759	52,597	3,027	4,949	8,390	3,205
PAT, Rs mn	20,502	36,686	1,972	4,083	5,200	2,168
EV/EBIDTA, x	21.8	14.1	13.5	18.5	17.1	10.2
EV/Sales, x	3.4	4.5	1.8	3.6	3.6	1.0

Source: Bloomberg, MF Global India Research Estimates

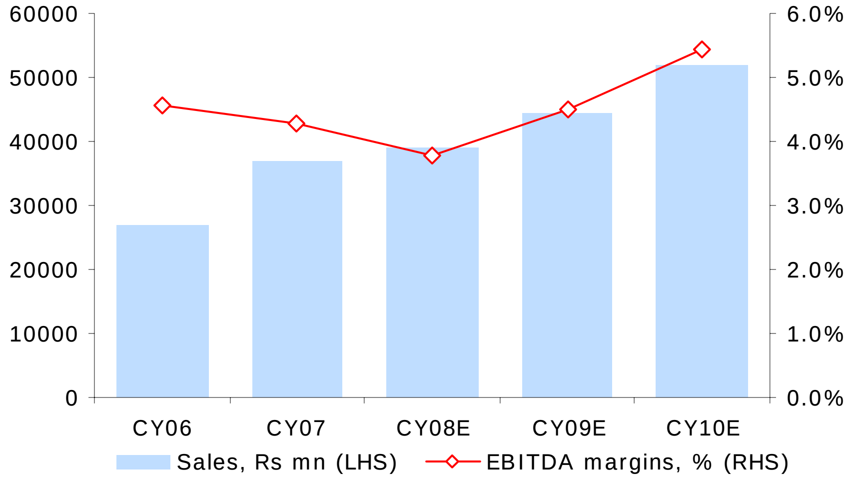
Agri growth to slow down with export ban of certain agri commodities

- Agri business has grown at a strong pace of 29.3% CAGR during FY04-FY07, led by higher exports of non-basmati rice, lead tobacco and wheat and new client acquisitions.

- Contribution from the choupal network has also grown during the period from Rs 500m in FY05 to Rs 1700mn in FY07. This has been led by a ramp up in network of e-choupal from 5200 to 6500 installations and choupal sagar from 3 to 21.

- In a scenario of rising food inflation, growth in the agri division is expected to be subdued. We believe that curbs on certain agri exports would limit the growth of the division.

Agri Business



ITC

Source: MF Global India Research Estimates

Profitability to improve with higher leaf tobacco exports

- With higher exports of leaf tobacco, we expect the division to record better profitability in the next two years.
- The revenues from Choupal network is expected to grow by 45.8% CAGR during FY07-FY10 to Rs 5277mn, led by higher income from the e-choupal network and growth in the choupal sagar network.
- The company plans to add about 20 choupal sagars every year to the current network of 21 choupal sagars.
- We expect agri revenues to grow by 12.1% CAGR to Rs 52bn during FY07-FY10E, primarily backed by higher leaf tobacco exports and contribution from choupal network.
- EBIDTA margins are also expected to improve by about 116bps to 5.4% due to higher realisations in leaf tobacco exports.

Agri division valued at Rs 2.4 per share

- We value ITC's agri division with the likes of Ruchi Soya.
- We believe that the division would attract a PE multiple of 8x, implying a price per share of Rs 2.4 during FY09E in view of its strong sourcing network of e-choupal and global reach, providing it the potential to ramp up its business, going forward.

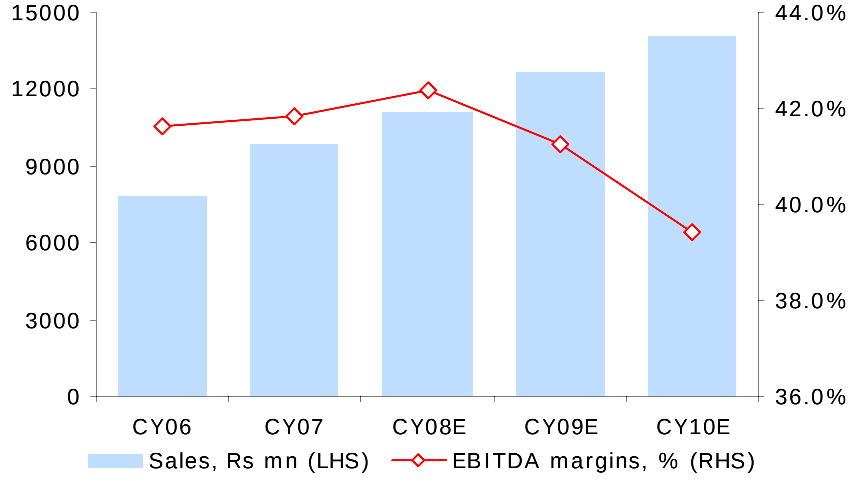
Rs mn	Ruchi Soya	Kohinoor Foods	KRBL	ITC
Sales FY09E	116,411	7,060	10,510	44,334
EBIDTA FY09E	4,742	803	1,377	1,997
PAT FY09E	1,575	314	519	1,110
EPS FY09E, Rs	9.8	10.6	21.3	0.3
EV/EBIDTA FY09E, x	5.05	8.6	5.2	-
P/E FY09E, x	8.9	10.6	5.4	8.0
ROCE FY07, %	15.0	13.8	-	10.0

Source: Bloomberg, MF Global India Research Estimates

Hotels have had a dream run, may witness slowdown

- **Inward traffic of foreign tourists have grown at 11.8% during CY01-CY06. We believe that India is growing as a prominent tourism destination.**
- Growing inward traffic from growth in the ITES business and tourism activity has propped strong growth in demand, resulting in a ARR growth of 33.8% CAGR in the ITC's key destinations during FY04-FY07.
- Resultantly, the division has witnessed robust improvement in EBIDTA margins in the last four years.
- With capacity additions coming in during the next two years, occupancy rates are expected to be under pressure, impacting ARR rates in key destinations.
- However, due to delays in capacity additions, hotel companies expect to maintain occupancy rates and grow revenues in double digit.

Hotels



Locations	Supply Growth		Demand Growth		ARR Growth	
	FY09E	FY10E	FY09E	FY10E	FY09E	FY10E
Agra	12.25	10.93	10	10	8	8
Chennai	36	53	15	25	-5	-10
Jaipur	17.8	5	15	12	10	10
New Delhi	23	23	15	15	-8	5
Bangalore	91	25	30	30	-5	8
Delhi	23	23	15	15	-8	5
Mumbai (South)	10	9.5	8	8	15	5
Mumbai (North)	24	14	20	15	12	0
Kolkata	18	75	10	25	15	0
Hyderabad	51	41	20	20	-10	-15

Source: CRIS Infac, MF Global India Research Estimates

Hotels to grow at 11.6% CAGR, valued at Rs 13.5 per share

- We expect a growth in hotel revenues to the tune of 11.6% CAGR during FY07-FY10 to Rs 13.7bn due to pressure on overall occupancy rates and ARRs.
- In addition, ITC's new property at Bangalore is expected to commence operations by the last quarter of FY09 and start contributing from FY10. This would aid revenue growth for the division during FY10.
- EBIDTA margins are expected to drop by about 222bps to 39.6% by FY10 with slower growth in ARRs and continued increase in cost from normal inflation and increase in capacity.
- We have valued the business on EV/EBIDTA basis in comparison with its peers, Indian hotels and Hotel Leela. We have applied an EV/EBIDTA of 10x in view of its higher margins and ROCEs over its peers, implying price per share of Rs 13.5.

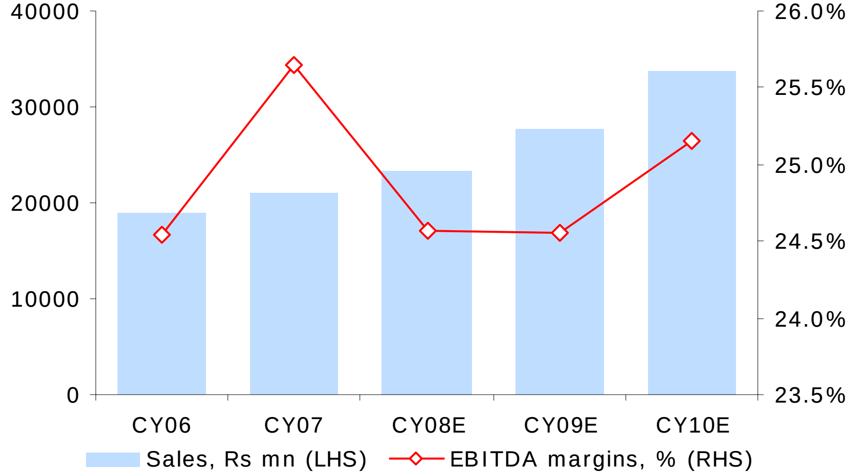
Rs mn	India Hotel	Hotel Leela	EIH	ITC
Sales FY09E	37,135	6,116	13,979	12,250
EBIDTA FY09E	10,894	2,822	4,704	5,074
PAT FY09E	5,767	1,439	3,046	3,067
EPS FY09E, Rs	7.5	3.3	7.8	0.81
EV/EBIDTA FY09E, x	9.2	9.1	13.4	10.0
P/E FY09E, x	15.0	12.2	17.6	16.9
ROCE FY07, %	15.4	8.2	16.9	25.0

Source: Bloomberg, MF Global Research Estimates

Paper division to grow on capacity additions

- With expected GDP growth of 7-8%, paper demand is expected to grow by 7-8% as it has a 1x correlation with GDP.
- ITC plans to grow through capacity additions in the paper business.
- Adding 100,000 tons per annum of paper capacity during Q2FY09 to primarily meet the stationery business and contribute to sales from FY09.
- Adding paper board capacity of 90,000 tons to be commissioned by Q4FY09 and therefore, would contribute during FY09-10.
- We estimate the division to sell about 42,454 tons of paper to the paper stationery during FY09 and about 80,474 tons of paper during FY10. We estimate total internal sales for ITC's paper division at Rs 12,289mn during FY09 and about Rs 14,780mn during FY10.
- We estimate ITC's total paper sales to grow by 17.1% CAGR to Rs 52,022mn during FY07-FY10 backed by capacity additions.

Paper & Packaging



ITC

Source: MF Global India Research Estimates

Paper valued at Rs 8.2 per share

- We expect that the profitability of the division will improve with higher utilisation levels.
- During the first 9 months of FY08, PBIT margins of the paper division has dropped by 146bps. Going forward with higher capacity utilisation levels, we estimate margins to improve by about 30bps to 24.9% by FY10.
- We have valued the business on a PE basis and have compared the same with leading writing and printing paper manufacturer, BILT.
- We believe that the division will attract PE of 8x in view of the higher EBIDTA margins over its peer with relatively strong ROCE of 18.7%.
- As compared to BILT's leadership position in value added writing and printing paper, ITC has a leading position in value-added paperboard.
- By applying a PE of 8x, we get a value of Rs 8.2 per share for ITC's paper business on FY09E.

Rs mn	Ballarpur Inds	ITC
Sales FY09E	30,491	27,796
EBIDTA FY09E	7,811	6,964
PAT FY09E	2,868	3,876
EPS FY09E, Rs	9.7	1.0
EV/EBIDTA FY09E, x	5.6	-
P/E FY09E, x	14.2	8.0
ROCE FY07, %	9.7	19.0

Source: Bloomberg, MF Global India Research Estimates

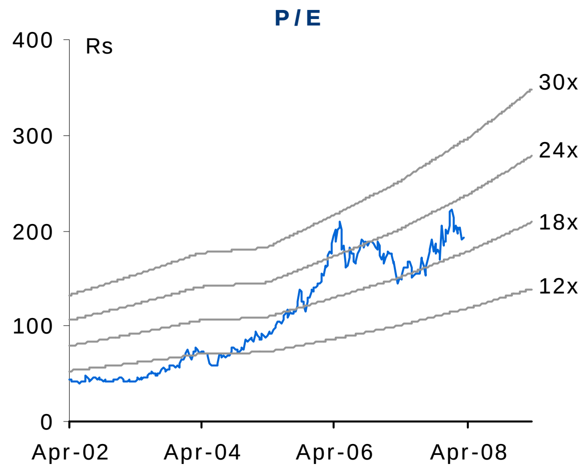
Sum-of-parts valuations gives a fair value of Rs 234

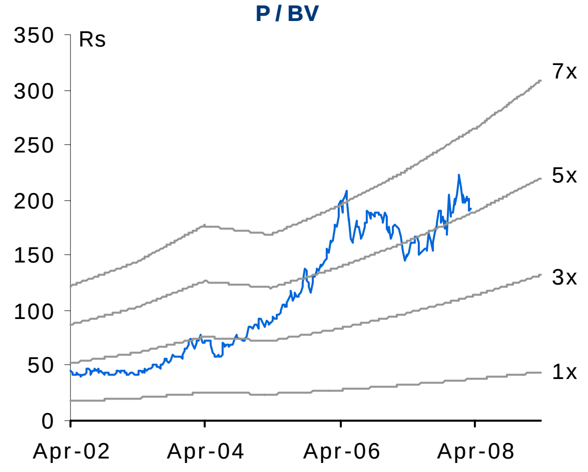
- ITC's gross sales expected to grow by 14% CAGR to Rs 28.9bn during FY07-FY10, led primarily by 8% CAGR in cigarettes, 49.9% CAGR in other FMCG and 17.1% CAGR in paper and paperboards.
- EBIDTA margins are expected to drop by 125bps to 30.7%, mainly due to increased contribution of non-cigarette divisions at 49.2% in FY10 against 39.8% in FY07.
- Profit after tax is expected to grow by 17.3% CAGR during FY07-FY10 to Rs 43.6bn, which implies an EPS of Rs 11.58 against Rs 7.17 in FY07.
- Our sum-of-parts valuation for all the divisions gives us an intrinsic value of Rs 234, implying a 13% appreciation from the current levels.

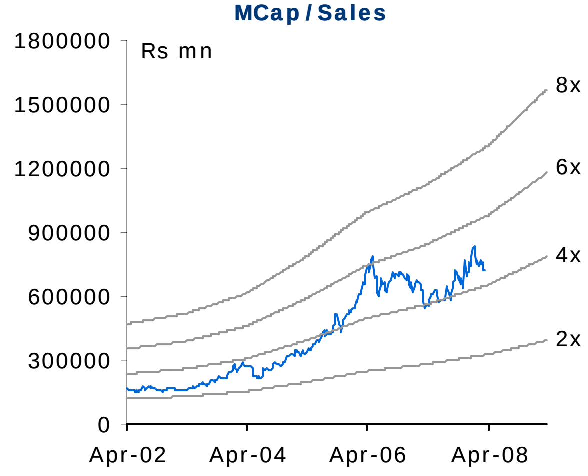
		FY09E
Cigarettes	EPS	8.2
Other FMCG	Sales	37560
Agri business	EPS	0.3
Paper	EPS	1.0
Hotels	EBIDTA	5078
Cigarettes	PE	20
Other FMCG	EV/sales	3
Agri business	PE	8
Paper	PE	8
Hotels	EV/EBIDTA	10
		Rs per share
Cigarettes		163.6
Other FMCG		29.9
Agri business		2.4
Paper		8.2
Hotels		13.5
		217.6
Equity shares (mn)		3,764
Debt (Less)		**0.5**
Cash (Add)		**16.5**
Fair value per share (Rs)		**234**

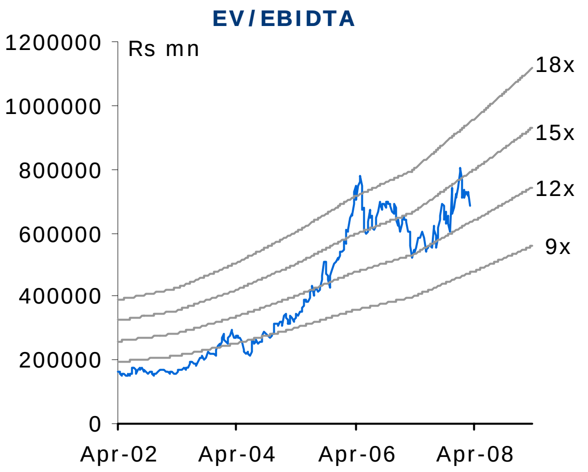
Source: MF Global India Research Estimates

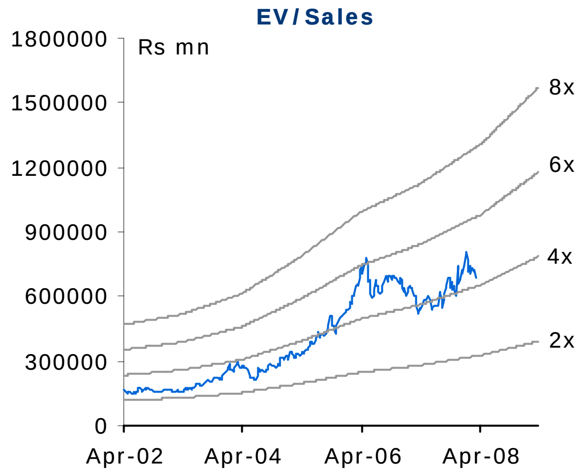
Absolute rolling Valuation band charts









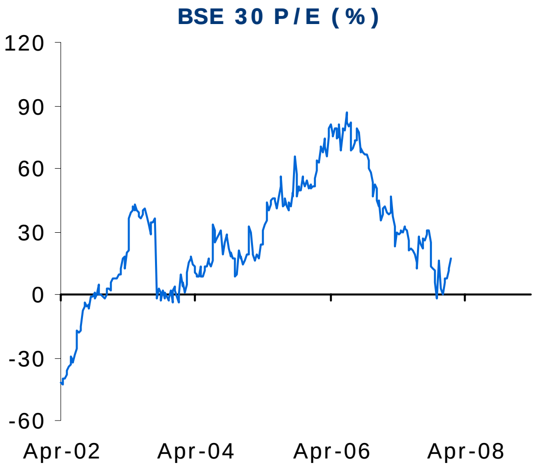


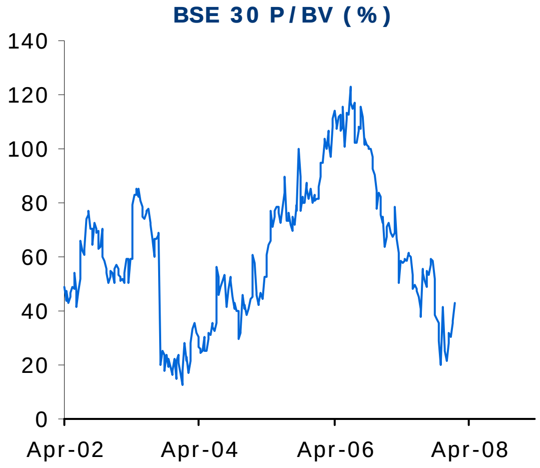
- ITC has witnessed a re-rating during FY02-FY05 with re-rating in its cigarettes division led by moderate taxation policy for cigarettes.

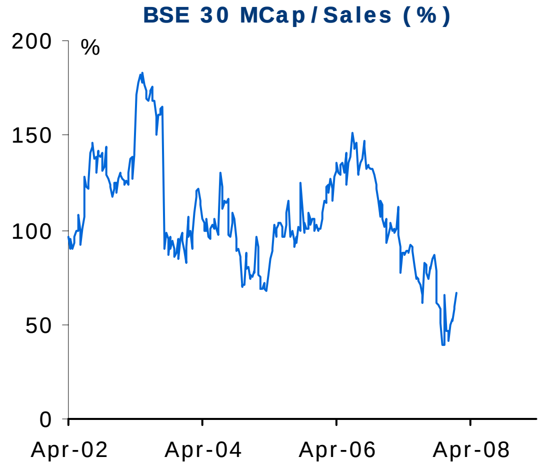
- However, due to a steep rise in cigarette duties, the stock witnessed an overall de-rating during the first half of FY08, but bounced back due to lower-than-expected volume drop.

Source: MF Global India Research

Premium discount to Sensex







- ITC premium over the benchmark index had risen during FY04-FY07 due to moderate taxation policy in cigarettes leading to a renewed volume growth in cigarettes.
- However, due to concerns raised from the substantial duty levy in FY08, the stock witnessed a de-rating and lowering of its premium over the benchmark index, which revived with lower-than-expected volume decline.

- Going forward, we believe that the stocks premium would be impacted in the short term due to concerns of the impact of sharp duty hike on non-filters. However, we believe that the stock would outperform the Sensex in the medium to long term and its premium over the index would improve with an increase in its dominance on the Indian cigarettes industry due to higher growth in the filters segment.

ITC

MF Global

Source: MF Global India Research

Key risks

Our Comments

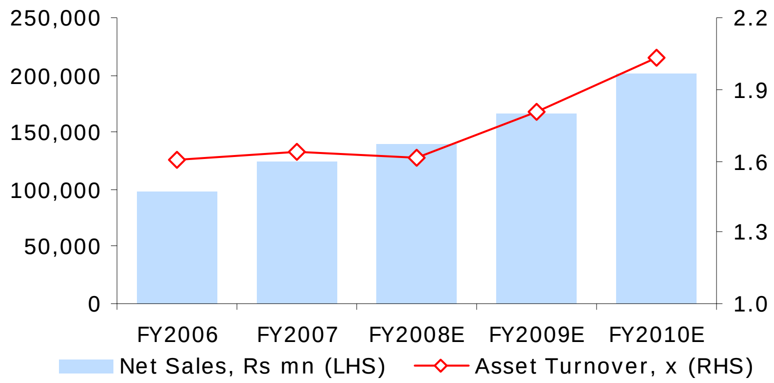
Risk	Our Comments
Sharp increase in excise duties on the filters segment in the coming years after the substantial increase in non-filters during FY09.	May require sharp price hikes and resultantly, may impact volumes and earnings of the cigarettes division and ITC as a whole
Delay in planned capacity additions in paper and hotels.	May impact revenues and corresponding earnings of the respective division
Strong competition from global players in personal care.	May require higher-than-expected time for the home and personal care business to breakeven due to higher ad-spends
Prolonged ban on exports of agri-products for a longer time	May impact earnings of the agri-division

Key Assumptions

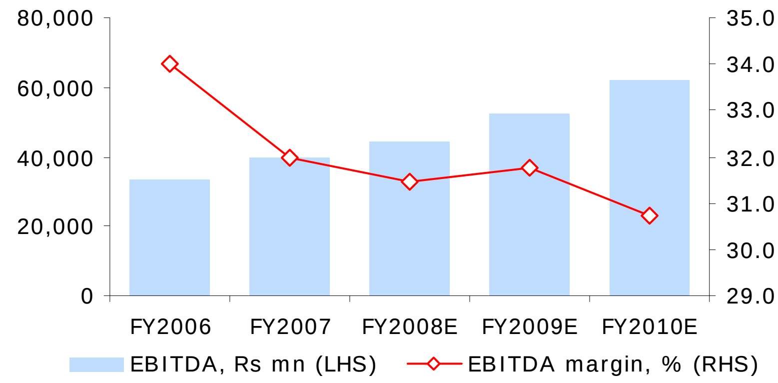
	FY08E	FY09E	FY10E
Sales, Rs mn			
Cigarettes	138,497	149,472	161,883
Other FMCG	25,198	37,560	57,400
Hotels	11,083	12,252	13,683
Agri-business	38,975	44,334	52,022
Paper & Packaging	23,376	27,796	33,737
EBIDTA, Rs mn			
Cigarettes	37,281	44,218	49,934
Margin (%)	26.9%	29.6%	30.8%
Other FMCG	-1,771	-2,720	-3,693
Margin (%)	-7.0%	-7.2%	-6.4%
Hotels	4,696	5,078	5,422
Margin (%)	42.4%	41.4%	39.6%
Agri-business	1,475	1,997	2,828
Margin (%)	3.8%	4.5%	5.4%
Paper & Packaging	5,742	6,964	8,383
Margin (%)	24.6%	25.1%	24.8%

Source: MF Global India Research Estimates

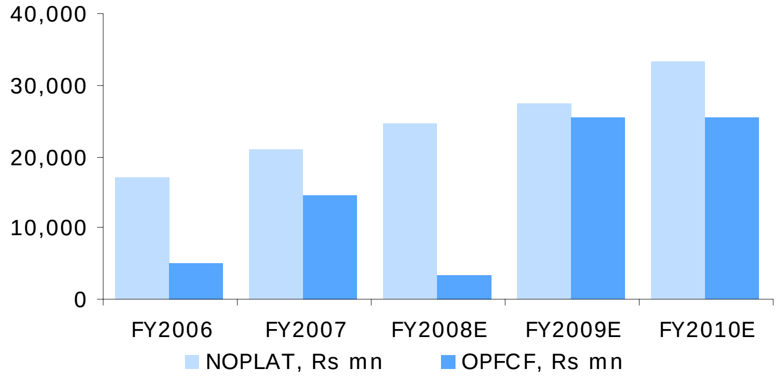
Financial Performance



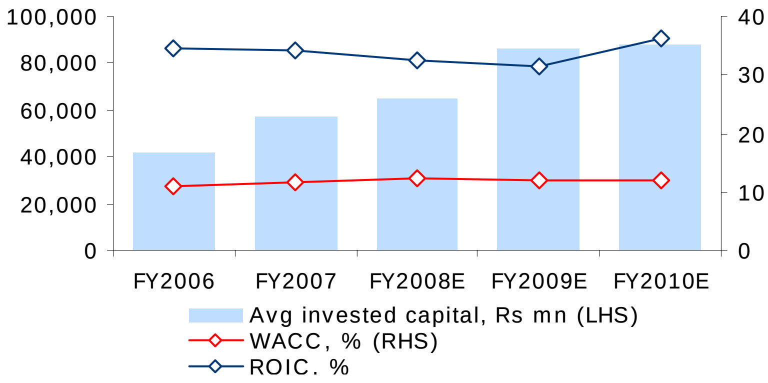
- Asset turnover to improve with higher utilisation levels in paper and growth in cigarettes and other FMCG.



- EBIDTA margins to drop with contribution from non-cigarette business.



- Free cash flow generation to improve with rising profitability in cigarettes.



- Return ratios to improve with better profitability in paper and expected improvement in cigarette margins.

Source: MF Global India Research Estimates

Financials

Income Statement

Y/E Mar, Rs mn	FY06	FY07	FY08E	FY09E	FY10E
Net sales	**97,905**	**123,693**	**140,623**	**165,493**	**201,711**
Growth, %	*28.2*	*26.3*	*13.7*	*17.7*	*21.9*
Other operating income	0	0	0	0	0
Total income	97,905	123,693	140,623	165,493	201,711
Operating expenses	-64,632	-84,129	-96,391	-112,896	-139,720
EBIDTA	**33,274**	**39,564**	**44,232**	**52,597**	**61,991**
Growth, %	*19.2*	*18.9*	*11.8*	*18.9*	*17.9*
Margin, %	*34.0*	*32.0*	*31.5*	*31.8*	*30.7*
Depreciation	-3,323	-3,629	-4,250	-4,700	-5,300
EBIT	**29,950**	**35,935**	**39,982**	**47,897**	**56,691**
Growth, %	*20.8*	*20.0*	*11.3*	*19.8*	*18.4*
Margin, %	*30.6*	*29.1*	*28.4*	*28.9*	*28.1*
Interest paid	-119	-33	-33	-33	-33
Other income	2,861	3,365	5,800	4,830	5,900
Pre-tax profit	**32,692**	**39,267**	**45,749**	**52,694**	**62,558**
Tax provided	**-9,888**	**-12,267**	**-14,337**	**-16,008**	**-18,967**
Profit after tax	**22,804**	**27,000**	**31,413**	**36,686**	**43,591**
Net Profit	**22,804**	**27,000**	**31,413**	**36,686**	**43,591**
MF Global Net profit	**22,804**	**27,000**	**31,413**	**36,686**	**43,591**
Growth, %	*24.1*	*18.4*	*16.3*	*16.8*	*18.8*
Unadj. shares (m)	3,755	3,755	3,755	3,755	3,755
Wtd avg shares (m)	3,764	3,764	3,764	3,764	3,764

Balance Sheet

Y/E Mar, Rs mn	FY06	FY07	FY08E	FY09E	FY10E
Cash & bank	8,558	9,002	25,984	39,693	58,423
Debtors	5,480	6,367	7,725	8,771	10,280
Inventory	26,363	33,540	41,595	47,230	55,352
Loans & advances	9,750	12,158	12,158	12,158	12,158
Other current assets	1,468	1,830	1,830	1,830	1,830
Total current assets	51,619	62,897	89,292	109,683	138,043
Investments	35,170	30,678	30,678	30,678	30,678
Gross fixed assets	62,272	71,343	79,343	89,843	100,843
Less: Depreciation	-20,654	-23,895	-28,145	-32,845	-38,145
Add: Capital WIP	2,434	8,661	2,434	2,434	2,434
Net fixed assets	44,051	56,109	53,632	59,432	65,132
Non-current assets	79,221	86,787	84,309	90,109	95,809
Total assets	**130,840**	**149,684**	**173,601**	**199,792**	**233,853**
Current liabilities	21,890	23,848	28,917	33,869	41,916
Total current liabilities	21,890	23,848	28,917	33,869	41,916
Non-current liabilities	18,335	21,466	23,134	24,296	26,435
Total liabilities	40,226	45,313	52,052	58,165	68,351
Paid-up capital	3,755	3,762	3,764	3,764	3,764
Reserves & surplus	86,860	100,609	117,786	137,863	161,738
Shareholders' equity	90,615	104,371	121,550	141,627	165,502
Total equity & liab	**130,840**	**149,684**	**173,601**	**199,792**	**233,853**

Source: MF Global India Research Estimates

Financials

Cash Flow

Y/E Mar, Rs mn	FY06	FY07	FY08E	FY09E	FY10E
Pre-tax profit	32,692	39,267	45,749	52,694	62,558
Depreciation	3,323	3,629	4,250	4,700	5,300
Chg in working capital	-2,782	-8,040	-1,987	697	2,057
Total tax paid	-10,075	-12,470	-15,123	-17,373	-20,569
CF from opg act	**23,158**	**22,387**	**32,889**	**40,718**	**49,346**
Capital expenditure	-5,381	-15,299	-1,773	-10,500	-11,000
Chg in investments	3,577	4,492	0	0	0
CF from invest act	**-1,805**	**-10,806**	**-1,773**	**-10,500**	**-11,000**
Free cash flow	19,548	774	29,344	19,718	27,346
Equity raised/(repaid)	1,273	7	2	0	0
Debt raised/(repaid)	-1,256	812	0	0	0
Dividend (incl. tax)	-10,091	-12,150	-14,136	-16,509	-19,616
Other financing activities	-2,827	194	0	0	0
CF from finan act	**-12,901**	**-11,137**	**-14,134**	**-16,509**	**-19,616**
Net chg in cash	8,452	443	16,982	13,709	18,730

Per-share data

Y/E Mar, Rs mn	FY06	FY07	FY08E	FY09E	FY10E
MF Global EPS (INR)	6.1	7.2	8.4	9.8	11.6
Growth, %	*3.1*	*18.4*	*16.3*	*16.8*	*18.8*
Book NAV/share (INR)	24.1	27.8	32.3	37.7	44.0
FDEPS (INR)	6.1	7.2	8.3	9.7	11.6
CEPS (INR)	6.9	8.1	9.5	11.0	13.0
CFPS (INR)	5.4	5.1	7.2	9.5	11.6
DPS (INR)	2.6	3.2	3.8	4.4	5.2

Ratios

Y/E Mar	FY06	FY07	FY08E	FY09E	FY10E
Return on assets (%)	18.6	19.3	19.4	19.7	20.1
Return on equity (%)	26.9	27.7	27.8	27.9	28.4
ROIC (%)	34.2	32.6	31.5	36.3	39.8
RoIC/Cost of capital (x)	2.9	2.7	2.6	3.0	3.3
RoIC - Cost of capital (%)	22.5	20.5	19.4	24.2	27.7
ROCE (%)	22.3	23.0	23.2	23.6	24.4
Cost of capital (%)	11.7	12.1	12.1	12.1	12.1
RoCE - Cost of capital (%)	10.6	10.9	11.2	11.5	12.3
Total debt/Equity (%)	1.3	1.9	1.7	1.4	1.2
Net debt/Equity (%)	(8.1)	(6.7)	(19.7)	(26.6)	(34.1)
Asset turnover (x)	1.6	1.6	1.6	1.8	2.0
Sales/Total assets (x)	0.8	0.9	0.9	0.9	0.9
Sales/Net FA (x)	2.3	2.5	2.6	2.9	3.2
Working capital/Sales (x)	0.2	0.2	0.2	0.2	0.2
Fixed capital/Sales (x)	0.0	0.0	-	-	-
Receivable days	20.4	18.8	20.1	19.3	18.6
Inventory days	98.3	99.0	108.0	104.2	100.2
Payable days	123.6	103.5	109.5	109.5	109.5
Current ratio (x)	2.4	2.6	3.1	3.2	3.3
Quick ratio (x)	1.2	1.2	1.6	1.8	2.0
Interest cover (x)	251.1	1,094.4	1,217.7	1,458.7	1,726.5
Dividend cover (x)	2.3	2.2	2.2	2.2	2.2
PER (x)	34.0	28.7	24.7	21.1	17.8
PEG (x) - y-o-y growth	10.9	1.6	1.5	1.3	0.9
Price/Book (x)	8.6	7.4	6.4	5.5	4.7
Yield (%)	1.3	1.6	1.8	2.1	2.5
EV/Net sales (x)	7.8	6.2	5.3	4.5	3.6
EV/EBITDA (x)	23.1	19.4	17.0	14.0	11.6
EV/EBIT (x)	25.6	21.4	18.8	15.4	12.7
EV/NOPLAT (x)	36.7	31.1	27.3	22.1	18.2
EV/CE	12.5	10.6	8.1	7.0	6.1
EV/IC (x)	12.6	10.1	8.6	8.0	7.2

Source: MF Global India Research Estimates

Appendix

Estimated brand contribution to category sales

	% of Total Category Sales
Skin Cream	**CY07**
FAL	65-70%
Ponds	9-10%
Vaseline	10-12%
Lakme	8-10%
Others	1-2%
Oral care	
Pepsodent	40-45%
Close UP	50-55%
Detergents	
Rin	22-25%
Surf Excel	22-25%
Wheel	45-50%
Soaps	
Lux	30-35%
Lifebuoy	30-35%
Liril	1.5-2%
Hamam	4-5%
Breeze	10-12%
Rexona	4-5%
Dove	1-2%
Pears	5-7%
Others	2-3%

Source: MF Global India Research

Price hikes in personal products

YoY (%)	CY04	CY05	CY06	CY07
Sunsilk	-20.6	3.4	4.5	1.3
Clinic Plus	-15.4	2.7	0	2.5
Clinic All Clear	5.1	7.5	-18.9	0
Clinic Plus Hair Oil	6.6	2	14.2	0
Clinic All Clear Hair Oil	4.1	1.9	13.1	0
FAL	0	2.9	7.1	4.3
Ponds	0	-1.4	-0.5	0
Pepsodent	0	3.8	3.5	0
Close Up	-7.2	0	2.4	1.2

Source: Bloomberg, MF Global India Research Estimates

Trend in key raw material prices

LAB	Price / ton	Gwth, %
CY03	869	7.0%
CY04	1,121	29.0%
CY05	1,265	12.9%
CY06	1,341	6.0%
CY07	1,469	9.6%

Palm Stearin	Price / ton	Gwth, %
CY03	369	11.3
CY04	415	12.6
CY05	342	-17.6
CY06	407	19.0
CY07	710	74.3

Soda Ash	Price Rs / 50kg	Gwth, %
CY05	3,159	
CY06	3,398	7.6
CY07	3,486	2.6

Source: Bloomberg, MF Global India Research Estimates

THANK YOU

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