# Adding ITC to top Buys

Model Portfolio

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Merrill Lynch

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## Adding ITC to Top Buys; removing ACC

The Union Budget has led to a sharp increase in the excise duty on ACC. While this is likely to be passed on to consumers in terms of a price increase tomorrow, we advise investors to use the bounce to reduce the exposure of the stock. Instead we are adding ITC to our Top buys. ITC has been a laggard over past year and the excise duty increase is lower than expected.

## ITC has under-performed on Tax fears that were overdone

ITC has been a big underperformer over the past year, being flat in a market that went up 25%. Fears of VAT and excise duty increases hit the stock. The excise duty increase at 5% is at the lower end of expectations. Moreover with no change in the Additional Excise Duty (AED), fears of imposition of VAT have eased. With the business likely to deliver around 20% growth, we increase its weight in our model portfolio.

## Use rally to cut weight to cement – Grasim now our top Buy

Following the excise duty increase, we expect cement stocks to no longer be strong performers in the market. We would advise investors to cut positions in these stocks on rallies over next few days as cement prices are increased. We are cutting weight to cement in our model portfolio. We now prefer Grasim as our cement pick (vs ACC and Ambuja earlier) on valuation grounds.

## Software still O/W – reiterate TCS as top pick

The budget has levied MAT on the software sector. While this will reduce the cash profits of companies (due to higher tax outflow), contrary to market fears, EPS impact is zero due to a corresponding deferred tax credit. The bigger worry is the impact on Fringe Benefit Tax (FBT) on ESOPs. TCS stands out as the best pick in the sector, given that it has no ESOPs.

## Budget will hit EPS growth for FY08 by 1-1.5%

We expect the budget to hit EPS growth for FY08 by around 1.5% due to slightly higher Corporate tax (due to additional 1% cess) and downgrades in cement sector and HDFC. Our bottom up Sensex EPS growth for FY08 is now 14% vs 34% in FY07. This is in line with our expectations that FY08 will see earnings slowing to 15-17% and will lead to a correction in the market in CY2007.

## We still expect markets to move lower – sell the rallies

Post the recent correction of nearly 11% over past 10 days, we could see a pullback in markets. However, we continue to expect markets to head lower (Sensex target remains 11500) as valuations de-rate led by rising interest rates, slowing earnings and increased supply of paper.

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Refer to important disclosures on page 9 to 11. Analyst Certification on page 7. Price Objective Basis/Risk on page 7.

# Model Portfolio

Table 1: Model Portfolio

| | Symbol | Rating | 28 Feb 2007 | MSCI Wt | Recommended ML Wt. | % Overweight |
|---|---|---|---|---|---|---|
| Industrials/Cement | | | | 9.4% | 14.5% | 54.2% |
| : Grasim | GRSJF | C-2-7 | 2,213 | | 3.0% | |
| : BHEL | BHRVF | C-1-7 | 2,177 | | 6.0% | |
| : L&T | LTOUF/LTORF | C-1-7/C-1-7 | 1,488 | | 5.5% | |
| Telecom | | | | 4.6% | 9.0% | 95.7% |
| : Bharti Tele | BHTIF | C-1-9 | 719 | | 6.0% | |
| : Reliance Communication | RLCMF | C-1-7 | 407 | | 3.0% | |
| Energy | | | | 17.1% | 15.0% | -12.3% |
| : Reliance | XRELF | B-1-7 | 1,355 | | 15.0% | |
| Software | | | | 23.0% | 24.0% | 4.4% |
| : TCS | TACSF | C-1-7 | 1,188 | | 10.0% | |
| : Infosys | INFYF/INFY | C-1-7/C-1-7 | 2,078 | | 8.0% | |
| : Satyam | SAYPF/SAY | C-1-7/C-1-7 | 413 | | 6.0% | |
| Financials | | | | 20.1% | 20.0% | -0.3% |
| : ICICI Bank | ICIJF/IBN | C-1-7/C-1-7 | 832 | | 11.0% | |
| : SBI | SBINF/SBKFF | C-1-7/C-1-7 | 1,039 | | 9.0% | |
| Pharma | | | | 5.0% | 4.0% | -19.5% |
| : Dr. Reddy's | DRRDF/RDY | C-1-7/C-1-7 | 677 | | 4.0% | |
| Consumer Discretionary | | | | 8.0% | 5.0% | -37.6% |
| : Maruti Udyog | MUDGF | C-1-7 | 840 | | 5.0% | |
| Consumer Staples | | | | 6.1% | 6.0% | -1.7% |
| : ITC | ITCTF/ITCTY | C-1-7/C-1-7 | 172 | | 6.0% | |
| Metals | | | | 3.1% | 0.0% | -100.0% |
| Others | | | | 3.7% | 2.5% | -31.6% |
| : NTPC | NTHPF | C-1-7 | 140 | | 2.5% | |

Source: Merrill Lynch Research

## Top Buys

Table 2: Top Buys

| Company | ML Symbol | QRQ | Price | Mkt Cap (US$mn) | Volume (US$mn) | Performance YTD | Performance 3month | PE FY06 | PE FY07E | PE FY08E | EPS CAGR 06-08E | RoE (%) FY07E | P/BV FY07E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ITC Limited | ITCTF | C-1-7 | 172 | 14,355 | 21.9 | -2% | -4% | 28.4 | 23.5 | 19.2 | 21% | 28.5 | 6.3 |
| Bharat Heavy | BHRVF | C-1-7 | 2,177 | 11,840 | 37.9 | -5% | -13% | 31.7 | 22.2 | 19.7 | 27% | 28.9 | 5.8 |
| Bharti | BHTIF | C-1-9 | 719 | 30,281 | 21.5 | 14% | 14% | 60.3 | 33.4 | 22.3 | 64% | 38.4 | 11.3 |
| Larsen & Toubro | LTOUF | C-1-7 | 1,488 | 9,269 | 28.8 | 3% | 8% | 38.9 | 27.6 | 21.6 | 34% | 28.0 | 6.9 |
| Tata Consultancy | TACSF | C-1-7 | 1,188 | 25,845 | 35.9 | -2% | 3% | 40.3 | 27.5 | 20.9 | 39% | 54.2 | 11.9 |

Source: Merrill Lynch Research

## Top Sells/ Underperformers

Table 3: Top Sells/ Underperformers

| Company | ML Symbol | QRQ | Price | Mkt Cap (US$mn) | Volume (US$mn) | Performance YTD | Performance 3month | PE FY06 | PE FY07E | PE FY08E | EPS CAGR 06-08E | RoE (%) FY07E | P/BV FY07E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Hero Honda | XHROF | C-3-7 | 676 | 2,998 | 7.9 | -11% | -9% | 13.9 | 15.0 | 14.0 | 0% | 40.3 | 5.5 |
| HLL | HINLF | C-3-7 | 176 | 8,638 | 20.6 | -19% | -26% | 29.6 | 25.2 | 21.6 | 17% | 61.9 | 14.5 |
| Tata Motors Ltd. | TENJF | C-2-7 | 784 | 6,712 | 31.7 | -13% | -3% | 19.1 | 14.1 | 13.0 | 21% | 32.4 | 4.1 |
| Ranbaxy Lab | XANBF | C-2-7 | 338 | 2,797 | 13.8 | -14% | -11% | 59.0 | 25.0 | 19.9 | 72% | 21.1 | 4.8 |
| Hindalco | HNDFF | C-3-7 | 140 | 3,598 | 20.0 | -20% | -21% | 8.6 | 6.3 | 12.4 | -17% | 23.9 | 1.3 |

Source: Merrill Lynch Research

## Top Mid-cap Buys

Table 4: Top Mid-cap Buys

| Company | ML Symbol | QRQ | Price | Mkt Cap (US$mn) | Volume (US$mn) | Performance YTD | Performance 3month | PE FY06 | PE FY07E | PE FY08E | EPS CAGR 06-08E | RoE (%) FY07E | P/BV FY07E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| IVRCL Infrastruc | IIFRF | C-1-7 | 291 | 834 | 33.9 | -25% | -30% | 43.8 | 29.2 | 18.6 | 53% | 15.9 | 2.9 |
| BIOCON LTD | BCLTF | C-1-7 | 458 | 1,017 | 6.0 | 23% | 26% | 26.3 | 24.0 | 17.1 | 24% | 19.7 | 4.4 |
| Panacea Biotec | XPEAF | C-1-7 | 426 | 621 | 1.2 | 8% | 24% | 50.2 | 21.4 | 16.0 | 77% | 63.3 | 10.4 |
| Sasken Communic | SKNCF | C-1-7 | 496 | 312 | 1.3 | -7% | 3% | 49.4 | 29.9 | 16.3 | 74% | 12.0 | 3.3 |
| Welspun India | WPNIF | C-1-9 | 78 | 125 | 0.1 | -8% | -16% | 15.9 | 10.9 | 7.3 | 48% | 10.1 | 1.0 |

Source: Merrill Lynch Research

# Adding ITC to our Top Buys

We are adding ITC to our top buys in India and increasing its weight in our model portfolio. The stock has been a major under-performer, remaining flat over the past year in a market that is up 25%. Fears of VAT have driven a de-rating of the stock. We believe post the budget these fears are behind us and look for the stock to deliver a strong return over the next year.

- **Excise increase of 5% is below market expectations**. We believe a 5% rate is very benign and in line with long term average growth rate in cigarette excise duties.
- **Additional Excise Duty retained – so no VAT?** The Government has retained AED in the current budget. This means that VAT on cigarettes is unlikely near term.
- **Expect profit growth of 20% over next 2 years:** ITC earnings remain insulated from rising interest rates, slowing global economy and worries on inflation. Our key assumptions are cigarette volume growth of 7-8% and EBIT margin expansion of 150bp.
- **Reasonable valuations:** ITC valuations look reasonable at 19xFY08E given that it is a virtual monopoly in perhaps the fastest growing large cigarette market. Strong growth appears sustainable given the huge potential for uptrading as cigarettes account for only 14% of tobacco consumption in India.

## Cutting cement in model portfolio – Grasim now top pick

Following the excise duty increase, we expect cement stocks to no longer be strong performers in the market. We would advise investors to cut positions in these stocks on rallies over next few days as cement prices are increased.

We are cutting weight to cement in our model portfolio. We now prefer Grasim as our cement pick (vs ACC and Ambuja earlier) on valuation grounds. Grasim is the cheapest cement stock on EV/EBIDTA, given the strong value accretion in its non-cement investments. (see Tables below).

Table 5: Sum of parts value for Grasim

| (Rsm) | FY08E |
|---|---|
| Enterprise value of Grasim Consolidated | 307,898 |
| | |
| Sum of parts valuation of Grasim's non-cement businesses | |
| VSF @ EV/EBITDA of 6-7x | 48,094 |
| Sponge Iron - zero value | - |
| Embedded value of investments | 17,871 |
| Value of Grasim's businesses other than cement (B) | 65,965 |
| | |
| Cement - Implied valuation [A-B] | 241,934 |
| Estimated EBITDA for Grasim's cement business - consolidated | 33,417 |
| Implied EV/EBITDA multiple for the cement business - consolidated | 7.2 |

Source: Merrill Lynch Research

Table 6: Valuations of Indian cement majors

| Yr to 31 March | FY05A | FY06A | 2006E/FY07E | 2007E/FY08E | 2008E/FY09E |
|---|---|---|---|---|---|
| EV/EBITDA (x) | | | | | |
| ACC | 23.0 | 19.6 | 9.8 | 8.5 | 9.8 |
| Grasim- Cement | 25.1 | 16.3 | 7.4 | 7.2 | 8.2 |
| Gujarat Ambuja | 19.3 | na | 9.0 | 8.3 | 9.8 |
| UltraTech | 34.3 | 21.3 | 8.8 | 8.1 | 10.2 |
| Shree Cement | 25.2 | 19.2 | 7.0 | 6.0 | 8.5 |
| India Cements | 30.8 | 22.1 | 8.2 | 6.7 | 7.9 |
| Local Market EV/EBITDA | 10.2 | 12.6 | 12.6 | 11.0 | 11.4 |
| P/E (x) | | | | | |
| ACC | 46.9 | 36.8 | 15.2 | 14.5 | 18.1 |
| Grasim- Overall | 21.0 | 19.1 | 10.5 | 10.2 | 13.7 |
| Gujarat Ambuja | 33.5 | na | 12.5 | 12.9 | 16.4 |
| UltraTech | 292.8 | 55.3 | 14.6 | 12.8 | 21.4 |
| Shree Cement | 48.6 | 27.1 | 10.1 | 10.7 | 22.6 |
| India Cements | na | 89.6 | 9.1 | 8.0 | 9.6 |
| Local Market PE | 30.6 | 25.6 | 19.9 | 17.2 | 15.1 |
| EV/Capacity (US$/ton) | | | | | |
| ACC (ADCLF, C-3-7/Sell) | 220 | 213 | 211 | 191 | 160 |
| Grasim (GRSJF/GRSJY, C-2-7/Neutral) | 162 | 161 | 157 | 166 | 113 |
| Gujarat Ambuja (XBRIF/GUJTF, C-3-7/Sell) | 257 | na | 241 | 219 | 222 |
| UltraTech (XDJNF, C-3-7/Sell) | 167 | 166 | 168 | 175 | 143 |
| Shree Cement (SREEF, C-3-7/Sell) | 365 | 210 | 214 | 163 | 107 |
| India Cements (INIAF/IAMZY, C-3-9/Sell) | 132 | 150 | 140 | 123 | 107 |
| REPLACEMENT COST BENCHMARK (India) | 80 | 80 | 80 | 80 | 81 |

Source: Merrill Lynch estimates

## Software companies – MAT impact negligible; TCS top pick

The budget has 3 proposals that hit the software industry:

1. Minimum Alternate Tax (MAT) made applicable to Indian IT and BPO companies, who currently claim Income Tax exemption u/s 10A (Software Technology Parks of India) and 10B. They would now have to pay 11.3% MAT on book profits of the Indian entity.
2. Fringe Benefit Tax on ESOPs at 33% on the difference between fair value on date of exercise (Market Price) and grant price for all ESOPs exercised after April 1, 2007
3. Service tax of 12.5% on commercial leases

While consensus was initially worried on MAT, we think the fears are lower than what the market expected.

### MAT – Likely to impact cash flow but not earnings

While the industry is still not completely clear on how MAT will be calculated for them, consensus appears to be that MAT would increase tax incidence to the extent of 11% on offshore profits less the tax they already pay on domestic business profits and interest income. Onsite profits (in foreign geographies like US etc) will not be subject to MAT, and would continue to attract taxes as today at local rates.

However, MAT can be carried forward and offset against future foreseeable profits when the industry is subject to tax from FY2010. Hence, there would be a credit on deferred tax in the profit and loss corresponding to the MAT tax paid. Thus there would be no impact on EPS though but cash flow would be impacted.

There also seems to be another view that MAT may be applied on entire book profit of the Indian entity, offset by the taxes paid onsite/on interest income earned in India / domestic profits. Given effective tax rate is above 11% in most cases, there would no incremental tax incidence in this scenario. Thus there will be no impact on cash profits also in this case.

However, companies with a subsidiary structure onsite would lose out since they would not be able to offset the taxes paid by their foreign subsidiary. Companies to be hit more in this situation would be companies like Tech Mahindra, Mastek, HCL Technologies and Patni.

## Fringe benefit tax on ESOPs

The Fringe benefit on ESOP is the bigger threat and can impact earnings by 10 to 20% if the current provision remains and vested ESOPs are not exercised before Mar 31 2007, but during FY08. However, industry is hopeful of converting the FBT on ESOPs to a withholding tax - a charge on employee rather than employer, on prospective basis and ‘persuading’ people to exercise before Mar 31st, 2007.

## Service tax on commercial leases

We expect service tax on commercial leases to be largely offset against service taxes collected on domestic services**.**

Table 7: India IT and BPO services : Summary impact on earnings and cash flow

| | Impact on earnings from | | Impact on cashflow (PAT+Dep.) | Business Model Onsite |
|---|---|---|---|---|
| | MAT | FBT on ESOP | MAT | |
| Infosys | Nil | Hi (~20%) | ~4% | Branch |
| Satyam | Nil | Med | ~3% | Branch |
| TCS | Nil | Nil | ~2% | Mostly branch |
| Wipro | Nil | Med (~11%) | ~2% | Branch |
| Infotech | Nil | Lo | ~3% | Subsidiary |
| Tech Mahindra | Nil | Hi (~20%) | ~6% | Subsidiary+Branch |
| Patni | Nil | Med | ~3% | Subsidiary |
| HCL Tech | Nil | Hi | n.a. | Subsidiary |
| Hexaware | Nil | Hi | ~3% | Subsidiary |
| WNS | Nil | Very Hi | ~10% | Subsidiary |
| Mastek | Nil | Lo | ~5% | Subsidiary |
| Mphasis BFL | Nil | Hi | ~3% | Subsidiary |
| Sasken | Nil | Lo | ~5% | Subsidiary |

Source: Assumed that companies will get the deferred tax asset credit in P/L with respect to any MAT paid; The FBT impact on ESOPs assumes a worst case scenario that all ESOPs which have vested are exercised after April 1, 2007 and employer has to bear the charge; Service Tax on lease rental will likely be offset against service tax income on domestic services

Source: Companies, Merrill Lynch Research

## Price Objective Basis & Risk

### ITC

Our PO of Rs200 is based on our target FY08 P/E of 22.5x. This implies a PEG of 1x which is in line with ITC's historic trends. A one-year forward multiple of 22.5x would also put ITC in line with Indian consumer sector average.

Risks to our rating and PO are a sharp increase in excise or VAT and slower than expected demand.

### TCS

Our Rs1,600 PO for TCS is set at 23x 1-yr rolling forward EPS. This is at a 5% discount to our target multiple for Infosys at 24x and lower than TCS' current 1yr forward PE of 26x. At our target price TCS would trade at 21x FY09E vs Infosys at 23x FY09E.

Risks: a) possible risks to margins from large deals, b) the ability to manage growth, c) lower wages than peers onsite, d) growing competition from western Systems Integrators like Accenture, e) industry wide risks of a slowdown in the US economy, higher than expected wage pressures and Rupee/USD appreciation.

## Analyst Certification

We, Jyotivardhan Jaipuria, Vandana Luthra, Reena Verma Bhasin, CFA and Mitali Ghosh, hereby certify that the views each of us has expressed in this research report accurately reflect each of our respective personal views about the subject securities and issuers. We also certify that no part of our respective compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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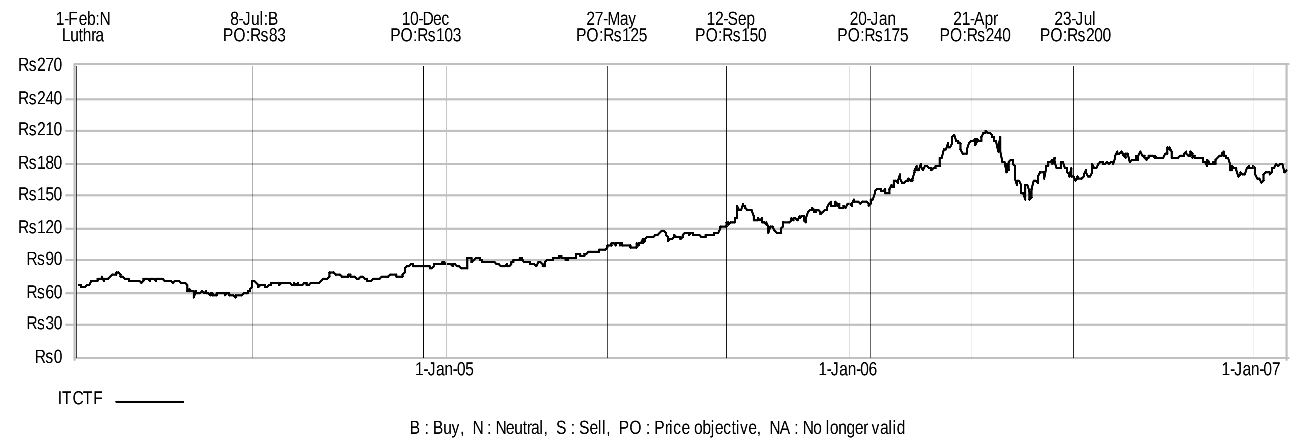
## ITCTF Price Chart

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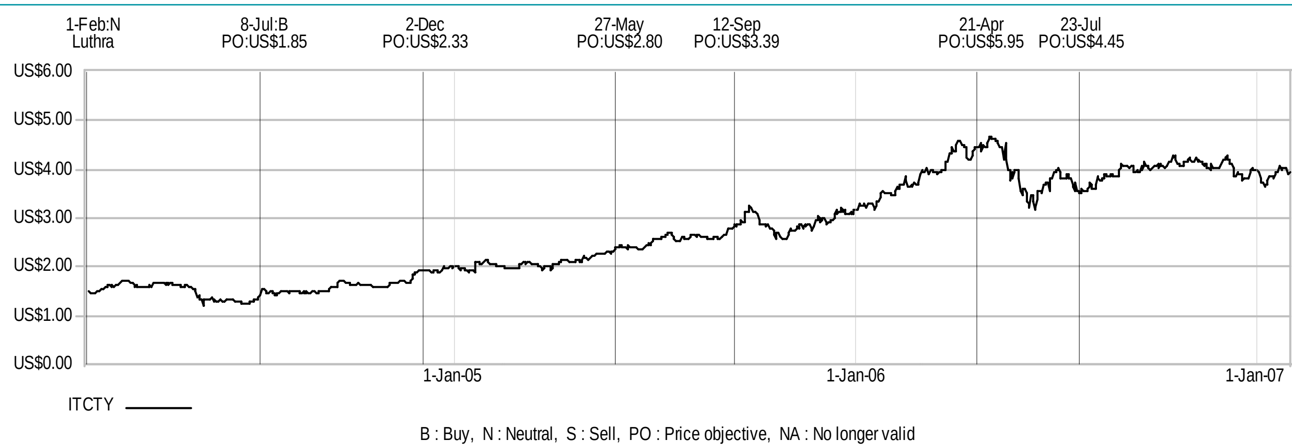
## ITCTY Price Chart

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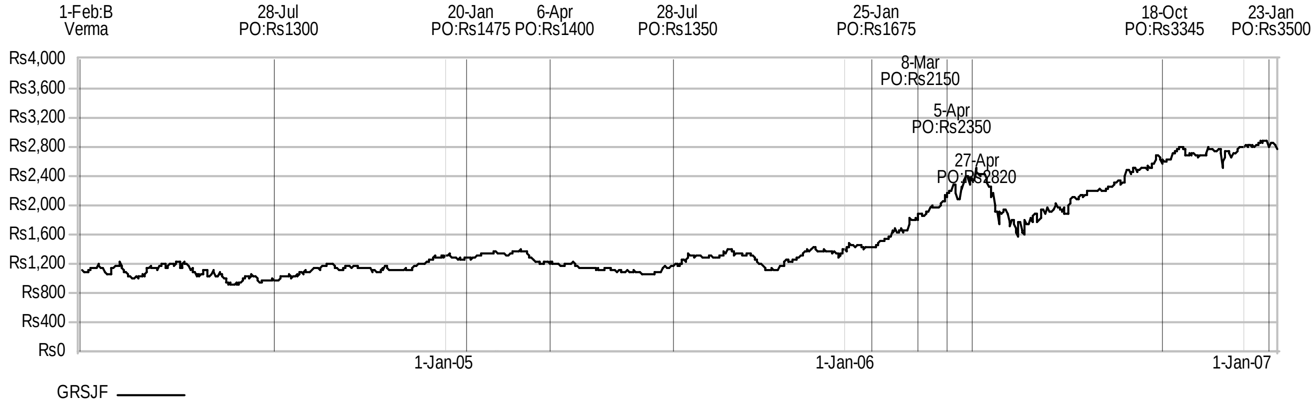
## GRSJF Price Chart




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

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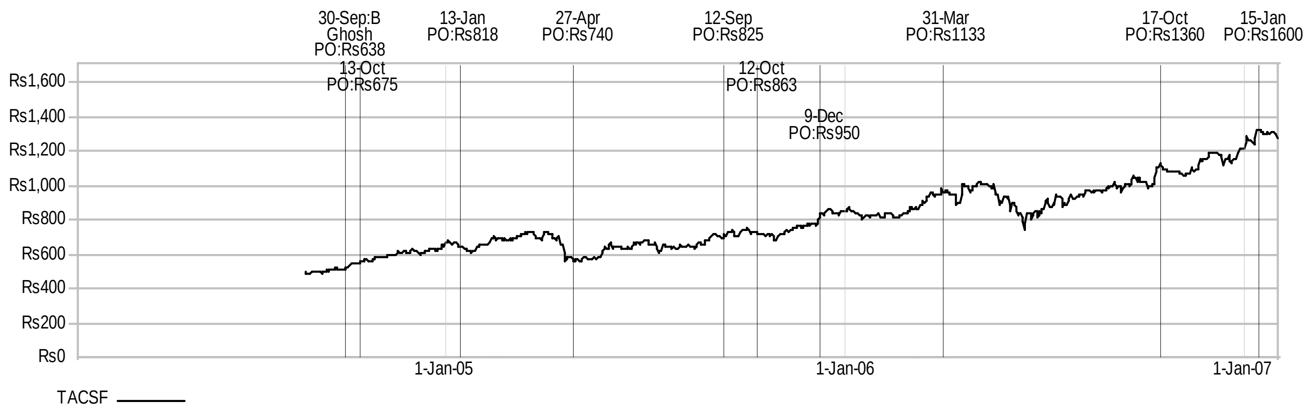
## TACSF Price Chart

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| Coverage Universe | Count | Percent | Inv. Banking Relationships* | Count | Percent |
|---|---|---|---|---|---|
| Buy | 39 | 65.00% | Buy | 8 | 20.51% |
| Neutral | 19 | 31.67% | Neutral | 3 | 15.79% |
| Sell | 2 | 3.33% | Sell | 1 | 50.00% |

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| Coverage Universe | Count | Percent | Inv. Banking Relationships* | Count | Percent |
|---|---|---|---|---|---|
| Buy | 104 | 41.94% | Buy | 19 | 18.27% |
| Neutral | 128 | 51.61% | Neutral | 24 | 18.75% |
| Sell | 16 | 6.45% | Sell | 2 | 12.50% |

### Investment Rating Distribution: Global Group (as of 31 Dec 2006)

| Coverage Universe | Count | Percent | Inv. Banking Relationships* | Count | Percent |
|---|---|---|---|---|---|
| Buy | 1306 | 42.74% | Buy | 406 | 31.09% |
| Neutral | 1509 | 49.38% | Neutral | 446 | 29.56% |
| Sell | 241 | 7.89% | Sell | 53 | 21.99% |

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