

August 12, 2008

India
India Consumer

ITC Limited (ITC.BO - INR 190.70) 3-Underweight

Change of Price Target

Not ready for a rethink

Manish Jain
91.22.4037.4186
manish.jain@lehman.com
LBSPL, India

Jamil Ansari
91.22.4037.4192
jamil.ansari@lehman.com
LBSPL, India

Investment Conclusion

□ We believe that the core cigarette business continues to face long-term concerns from: a) the increasing threat from contraband cigarettes at the lower end and smuggled brands at the higher end; b) continuous regulatory pressure and a possible significant hike in the filtered cigarette excise duty; and c) margin pressure on account of rising tobacco prices. Further, the investment in the newer ventures is likely to be significantly higher than the consensus estimates. We reduce our target price to INR 172 and maintain our 3-underweight rating.

Summary

- We are reducing our EPS estimate by 12.3% and 11% for FY09E and FY10E respectively on the back of: a) margin pressure in cigarette business; and b) higher losses in the newer businesses.
- While we view the recent numbers in the cigarette business as encouraging, we believe that long-term concerns remain intact.
- Investment in the personal product business is to remain high in the coming years. The business is likely to break even in FY11E.

Stock Rating

New: 3-Underweight
Old: 3-Underweight

Target Price

New: INR 172.00
Old: INR 178.00

Sector View: 1-Positive

FY Mar Currency INR	2008A	2009E		2010E		2011E	
	Actual	Old	New	Old	New	Old	New
Revenue (m)	147877.0	172705.0	168960.0	193397.0	192479.0	N/A	N/A
Net Profit (m)	30255.0	37361.0	32824.0	43229.0	38541.0	N/A	N/A
EPS	8.00	9.90	8.70	11.50	10.20	N/A	N/A
EPS growth (%)	10.50	16.60	8.50	16.00	17.40	N/A	N/A
P/E	23.84	19.26	21.92	16.58	18.70	N/A	N/A
EV/EBITDA	14.3	N/A	13.1	N/A	11.1	N/A	N/A

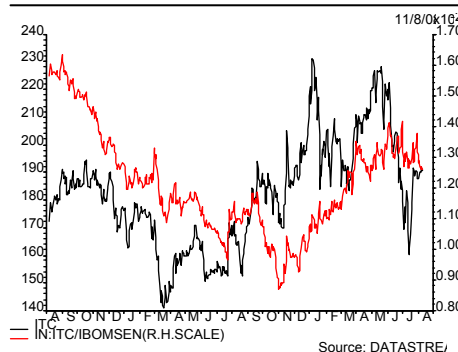
Market Data

Market Cap (mn)	718674
Market Cap (US\$ mn)	17085
Shares Outstanding (mn)	3768.6
6mth Daily T/O (US\$ mn)	30.70
Free float (%)	67.90
Share per ADR	N/A

Financial Summary

Proj 3-Yr EPS Grth(%)	10.5
ROE (%)	25.7
Debt / Capital (%)	1.6
Dividend Yield (%)	2.80

Stock Overview



Reuters ITC.BO
Bloomberg ITC IN
ADR

Performance	1M	3M	12M
Absolute %	9.3	-12.6	16.7
Rel. Market %	-2.8	-2.3	12.8
Rel. Sector %	N/A	N/A	N/A

52 Week Range 231.10 - 152.20

We are reducing our EPS estimate by 12.3% and 11% for FY09E and FY10E respectively. Our FY09E and FY10E EPS now stand at INR 8.7 and 10.2 for FY09E and FY10E respectively. The downgrade is primarily on account of the following reasons:

- We have incorporated the audited FY08 results in to our earnings model. The base FY08 EPS now stands as INR8.0.
- We are now building INR 3.8bn loss in FY09 in the “other businesses” comprising primarily of foods and personal products. These losses would be on account of a) increased promotional expenses in the personal care products, and b) margin pressure in the foods business.
- For the hotels business, we are now building in a 140bps decline in the operating margins in FY09E from 37.4% to 36% against our earlier estimate of flattish margins. This margin decline would be primarily on account of seasonality in the business.
- In the core cigarettes business, while our volume and realisations assumptions remain unchanged, we are now building in a margin decline of 30bps in FY09E. This margin decline would be primarily on account of the incorporation of certain one time expenses related to the migration from unfiltered to filtered cigarettes and higher fixed expenses.

Lehman Brothers does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report.

Investors should consider this report as only a single factor in making their investment decision.

This research report has been prepared in whole or in part by research analysts that are not registered/qualified as research analysts with FINRA.

PLEASE SEE ANALYST(S) CERTIFICATION(S) ON PAGE 3 AND IMPORTANT DISCLOSURES INCLUDING FOREIGN AFFILIATE DISCLOSURES BEGINNING ON PAGE 4

Figure 1: ITC: Earnings change

INR mn	FY09E			FY10E		
	Old Estimates	New Estimates	Change (%)	Old Estimates	New Estimates	Change (%)
Revenue	172,705	168,960	(2.2)	193,397	192,479	(0.5)
EBITDA	57,259	51,764	(9.6)	66,045	61,350	(7.1)
EBITDA Margin (%)	33.2	30.6	N.A	34.1	31.9	N.A
PAT	37,361	32,824	(12.1)	43,229	38,541	(10.8)
EPS	9.9	8.7	(12.3)	11.5	10.2	(11.0)

Source: Lehman Brothers Research

Cigarette business: Concerns remain

Cigarette business reported what we consider to be encouraging numbers in the recently announced Q1FY09 results with volumes declining by only 3%. According to the company, there has been ~80% migration from plains (large unfiltered cigarettes) to filtered cigarettes, which is significantly higher not only than the consensus estimates but also the company's own expectations. Adjusted for INR 200mn one time expense owing to the discontinuation of the unfiltered cigarette business, operating profit for the cigarette business has increased by ~5%. Management has guided for a high single digit growth in the cigarette profits going forward.

While the Q1FY09 numbers were significantly better than consensus, they were in-line with our expectations. Our full year numbers built in a 3.8% volume decline (after factoring in migration in-line with the current quarter numbers) and a ~10% realisation jump. We have factored in a 30bps YoY decline in the operating margins.

Further, we believe that there are several long term concerns that would continue to pose a problem for the company's core business:

- Competition from contraband cigarettes at the lower end:** over the last few months several low-cost filter cigarette brands such as Clock, Supermatch, Indus and Fursat have mushroomed illegally. These contraband cigarettes have witnessed a rapid 20-30% volume growth over the last four to five months and now account for ~5% of industry volumes. These brands have been the primary reason for zero migration in the micros (small unfiltered cigarettes) and are increasingly becoming very popular amongst consumers. These contraband cigarettes could be a big threat in the coming months.
- Excise duty hike in filtered cigarettes:** We believe that there is a fair chance that excise duty on filtered cigarettes could be hiked substantially in the next year's budget given that a) tobacco and alcohol products are always a easy target to mop up additional revenue, and b) government's stated intent of curbing the tobacco consumption in the country.
- Increasing tobacco prices:** This season, tobacco prices have witnessed a jump of ~78% YoY to INR 84/kg in the Andhra Pradesh auctions. Reports have indicated that these prices could jump even further in the upcoming season, which could potentially hurt margins in the cigarette business.
- Continuous regulatory pressure:** Over the last couple of years, the union government has become very aggressive in targeting the smoking form of tobacco consumption. Recent measures such as banning of smoking in public place and pictorial warnings would hurt the long term growth prospects of the company. Further, our interaction with the management indicates that the company too seems to be concerned about the future of the cigarettes business in India.

Newer ventures: mounting losses

The company has reported a loss of INR 1.2bn in the foods and personal care business in Q1FY09. This is significantly higher than both our own as well as consensus estimates. This was primarily on account of: a) margin pressure in the foods business, particularly the biscuits portfolio where the company is yet to take a price increase this year, and b) increased investment in the personal care business that has witnessed a spate of new launches.

Management has indicated that it is looking to increase its biscuit prices in the coming few months. Further, over the next few quarters, the personal products business is also likely to achieve scale and reduced launch expenses. Thus, while the Q2FY09E losses are likely to be similar, there is likely to a significant dip in losses post that. We have assumed a loss of INR 3.8bn in FY09E in this segment.

Sum-of-the-parts valuation

We have valued the core cigarette business at INR 114 per share based on a P/E multiple of 16x FY09E earnings of INR7.3.

The other core businesses are valued at around INR 51 per share. We have valued the net cash (after deducting corporate expenses) at book value based on FY09E balance sheet.

Figure 2: Sum-of-the-parts valuations

	Per share (INR)	Comment
Cigarettes	114	P/E multiple of 16x
Hotels	12	P/E multiple of 16x
Paper	9	EV/EBIT of 6x
Agri Business	4	0.5x sales
New Venture	27	2.75x sales
Core business	166	
Net Cash	6	
Total	172	

Source: Company, Lehman Brothers Research

Conclusion

We believe that the core cigarette business continues to face long-term concerns from: a) the increasing threat from contraband cigarettes at the lower end and smuggled brands at the higher end; b) continuous regulatory pressure and a possible significant hike in the filtered cigarette excise duty; and c) margin pressure on account of rising tobacco prices. Further, the investment in the newer ventures is likely to be significantly higher than consensus estimates.

We reduce our target price to INR 172 and maintain our 3-Underweight rating.

Figure 3: Income Statement

Year ended 31 Mar (INR mn)	FY05	FY06	FY07	FY08	FY09E	FY10E
Net sales	81,223	104,225	129,493	147,877	168,960	192,479
growth (%)	17.3	28.3	24.2	14.2	14.3	13.9
Operating expenses	-51,548	-68,652	-87,660	-100,709	-117,196	-131,129
Operating profit	29,675	35,573	41,833	47,168	51,764	61,350
Other income	1,462	1,998	2,470	3,182	3,274	3,294
EBITDA	31,137	37,571	44,303	50,349	55,038	64,645
Depreciation	-3,366	-3,595	-3,938	-4,729	-5,810	-6,885
EBIT	27,770	33,976	40,365	45,621	49,227	57,760
Interest paid	-501	-173	-96	-192	-236	-236
Non-recurring items (net of taxes)	3,949	-481	222	1,323	0	0
Pre-tax profit	31,218	33,322	40,491	46,752	48,991	57,523
Tax (current + deferred)	-8,629	-10,239	12,747	-14,970	-16,167	-18,983
Profit after tax	22,589	23,083	27,743	31,782	32,824	38,541
Minority interests	-135	-129	-191	-204	0	0
Net profit	22,454	22,954	27,553	31,578	32,824	38,541
Adjusted net profit	18,505	23,435	27,331	30,255	32,824	38,541
growth (%)	15.6	26.2	16.4	10.5	8.5	17.4

Source: Company, Lehman Brothers Research

Figure 4: Balance Sheet

Year ended 31 Mar (INR mn)	FY05	FY06	FY07	FY08U	FY09E	FY10E
Current assets	40,257	56,555	69,346	73,340	87,437	93,574
Investments	33,291	29,981	25,059	26,079	26,079	26,079
Net fixed assets	43,836	47,612	59,760	78,193	80,818	93,933
Total assets	117,385	134,148	154,164	177,611	194,334	213,585
Current liabilities	31,135	36,401	39,906	45,921	52,468	59,771
Total Debt	2,470	1,467	2,009	2,249	2,249	2,249
Other liabilities	3,762	3,255	4,713	5,436	5,436	5,436
Total liabilities	37,367	41,122	46,628	53,606	60,153	67,456
Share capital	3,741	3,755	3,762	3,769	3,769	3,769
Reserves & surplus	75,643	88,453	102,698	119,105	129,281	141,228
Shareholders' funds	79,385	92,208	106,461	122,874	133,049	144,997
Minorities	634	818	1,076	1,132	1,132	1,132
Total equity & liabilities	117,385	134,148	154,164	177,611	194,334	213,585

Source: Company, Lehman Brothers Research

Analyst Certification:

We, Manish Jain and Jamil Ansari, hereby certify (1) that the views expressed in this research Company Note accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Company Note and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Company Note.

Company Description:

ITC is one of India leading cigarette players with a volume share of nearly 75%. Over the last few years the company has started to diversify into a host of new businesses like personal care products and foods.

Important Disclosures:

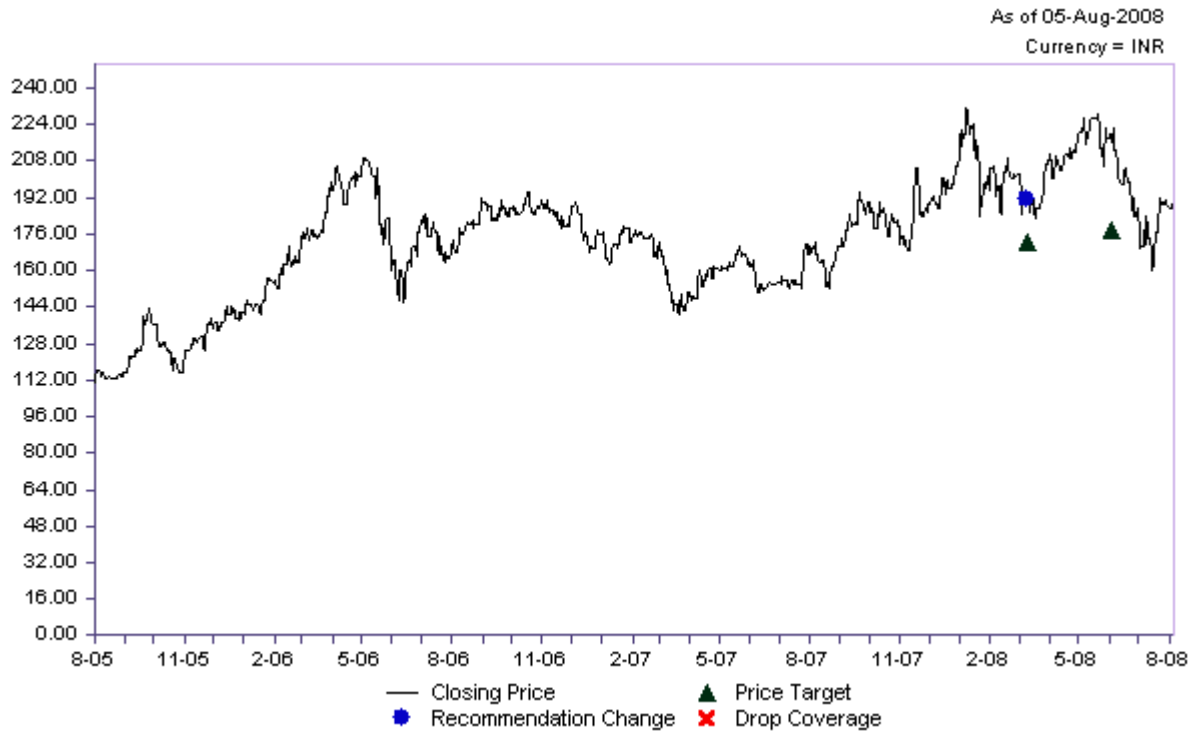
ITC Limited (ITC.BO)

INR 190.70 (08-Aug-2008)

3-Underweight / 1-Positive

Rating and Price Target Chart:

ITC LIMITED



Currency=INR

Date	Closing Price	Rating	Price Target
03-Jun-08	219.45		178.00
10-Mar-08	190.60		172.00

Date	Closing Price	Rating	Price Target
10-Mar-08	190.60	3 -Underweight	

FOR EXPLANATIONS OF RATINGS REFER TO THE STOCK RATING KEYS LOCATED ON THE PAGE FOLLOWING THE LAST PRICE CHART.

Lehman Brothers Inc. and/or an affiliate trade regularly in the shares of ITC Limited.

Valuation Methodology: We value the company using a sum-of-the-parts valuation methodology. We value the core cigarette business at INR 114 per share based on a P/E multiple of 16x FY09E earnings of INR7.3. The other core businesses are valued at around INR 51 per share. We have valued the net cash (after deducting corporate expenses) at book value based on FY09E balance sheet.

Risks Which May Impede the Achievement of the Price Target: We believe the government's taxation policy is the biggest determinant of cigarette volumes. In a benign policy environment, there could be upside risk to our volume growth assumptions. Furthermore, if government policy were to focus on other forms of tobacco consumption, then cigarette sales may see an uptick in the short term.

Important Disclosures Continued:

The analysts responsible for preparing this report have received compensation based upon various factors including the firm's total revenues, a portion of which is generated by investment banking activities

With the exception of analysts who publish for either LBI or a branch of LBI, research analysts may not be associated persons of the member and therefore may not be subject to Rule 2711 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account.

Company Name	Ticker	Price	Price Date	Stock / Sector Rating
ITC Limited	ITC.BO	INR 190.70	08-Aug-2008	3-Underweight / 1-Positive

Guide to Lehman Brothers Equity Research Rating System:

Our coverage analysts use a relative rating system in which they rate stocks as 1-Overweight, 2-Equal weight or 3-Underweight (see definitions below) relative to other companies covered by the analyst or a team of analysts that are deemed to be in the same industry sector (the "sector coverage universe"). Below is the list of companies that constitute the sector coverage universe:

Asian Paints (ASPN.NS)	Dabur India (DABU.NS)
Godrej Consumer (GOCP.NS)	Hindustan Unilever Limited (HLL.BO)
ITC Limited (ITC.BO)	Marico Limited (MRCO.NS)
Tata Tea (TTTE.BO)	United Spirits (MCDO.NS)

In addition to the stock rating, we provide sector views which rate the outlook for the sector coverage universe as 1-Positive, 2-Neutral or 3-Negative (see definitions below). A rating system using terms such as buy, hold and sell is not the equivalent of our rating system. Investors should carefully read the entire research report including the definitions of all ratings and not infer its contents from ratings alone.

Stock Rating

1-Overweight - The stock is expected to outperform the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

2-Equal weight - The stock is expected to perform in line with the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

3-Underweight - The stock is expected to underperform the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

RS-Rating Suspended - The rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Lehman Brothers is acting in an advisory capacity in a merger or strategic transaction involving the company.

Sector View

1-Positive - sector coverage universe fundamentals/valuations are improving.

2-Neutral - sector coverage universe fundamentals/valuations are steady, neither improving nor deteriorating.

3-Negative - sector coverage universe fundamentals/valuations are deteriorating.

Distribution of Ratings:

Lehman Brothers Equity Research has 2079 companies under coverage.

45% have been assigned a 1-Overweight rating which, for purposes of mandatory regulatory disclosures, is classified as Buy rating, 35% of companies with this rating are investment banking clients of the Firm.

39% have been assigned a 2-Equal weight rating which, for purposes of mandatory regulatory disclosures, is classified as Hold rating, 34% of companies with this rating are investment banking clients of the Firm.

13% have been assigned a 3-Underweight rating which, for purposes of mandatory regulatory disclosures, is classified as Sell rating, 23% of companies with this rating are investment banking clients of the Firm.

Lehman Brothers Inc. and Its Foreign Affiliates Involved in the Production of Equity Research

New York	London	Tokyo
Lehman Brothers Inc. (LBI, New York) 745 Seventh Avenue New York, NY 10019 Member, FINRA	Lehman Brothers International (Europe) (LBIE, London) 25 Bank Street London, E14 5LE, United Kingdom Regulated by FSA	Lehman Brothers Japan Inc. (LBJ, Tokyo) Roppongi Hills Mori Tower, 31st Floor 6-10-1 Roppongi, Minato-ku, Tokyo 106-6131, Japan Regulated by FSA

Mumbai Lehman Brothers Inc., India Branch (LBI, India) Winchester, Off High Street, 9th Floor Hiranandani Business Park, Powai, Mumbai 400 076, India	Seoul Lehman Brothers International (Europe) Seoul Branch (LBIE, Seoul) Hanwha Building, 12th Floor 110, Sokong-dong Chung-Ku Seoul 100-755, Korea Regulated by FSC	Hong Kong Lehman Brothers Asia Limited - Hong Kong (LBAL, Hong Kong) Two International Finance Centre 8 Finance Street, 26th Floor Central, Hong Kong Regulated by SFC
Mumbai Lehman Brothers Securities Private Limited (LBSPL, India) Ceejay House, 11th Level, Plot F, Shivsagar Estate, Dr. Annie Besant Road, Worli, Mumbai 400018 Regulated by SEBI	Taipei Lehman Brothers Securities Taiwan Limited (LBSTL, Taiwan) Cathay Financial Center 12F 7 Sungren Road - Shin-Yi District Taipei, Taiwan Regulated by FSC	Sydney Lehman Brothers Australia Limited (LBAUL, Sydney) Level 33, 264 George Street Sydney NSW 2000, Australia Regulated by ASIC

This material has been prepared and/or issued by Lehman Brothers Inc., member SIPC, and/or one of its affiliates ("Lehman Brothers") and has been approved by Lehman Brothers International (Europe), authorized and regulated by the Financial Services Authority, in connection with its distribution in the European Economic Area. This material is distributed in Japan by Lehman Brothers Japan Inc., and in Hong Kong by Lehman Brothers Asia Limited. This material is distributed in Australia by Lehman Brothers Australia Limited, and in Singapore by Lehman Brothers Singapore Pte Ltd. Where this material is distributed by Lehman Brothers Singapore Pte Ltd, please note that it is intended for general circulation only and the recommendations contained herein does not take into account the specific investment objectives, financial situation or particular needs of any particular person. An investor should consult his Lehman Brothers' representative regarding the suitability of the product and take into account his specific investment objectives, financial situation or particular needs before he makes a commitment to purchase the investment product. This material is distributed in Korea by Lehman Brothers International (Europe) Seoul Branch, and in Taiwan by Lehman Brothers Securities Taiwan Limited. Where this material is distributed by Lehman Brothers Securities Taiwan Limited, please note that recommendations expressed herein are for reference only. Investors should carefully evaluate the investment risks and are reminded that they are solely responsible for their investment decisions. This document is for information purposes only and it should not be regarded as an offer to sell or as a solicitation of an offer to buy the securities or other instruments mentioned in it. No part of this document may be reproduced in any manner without the written permission of Lehman Brothers. With the exception of disclosures relating to Lehman Brothers, this research report is based on current public information that Lehman Brothers considers reliable, but we make no representation that it is accurate or complete, and it should not be relied on as such. In the case of any disclosure to the effect that Lehman Brothers Inc. or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company, the computation of beneficial ownership of securities is based upon the methodology used to compute ownership under Section 13(d) of the United States' Securities Exchange Act of 1934. In the case of any disclosure to the effect that Lehman Brothers Inc. and/or its affiliates hold a short position of at least 1% of the outstanding share capital of a particular company, such disclosure relates solely to the ordinary share capital of the company. Accordingly, while such calculation represents Lehman Brothers' holdings net of any long position in the ordinary share capital of the company, such calculation excludes any rights or obligations that Lehman Brothers may otherwise have, or which may accrue in the future, with respect to such ordinary share capital. Similarly such calculation does not include any shares held or owned by Lehman Brothers where such shares are held under a wider agreement or arrangement (be it with a client or a counterparty) concerning the shares of such company (e.g. prime broking and/or stock lending activity). Any such disclosure represents the position of Lehman Brothers as of the last business day of the calendar month preceding the date of this report. This material is provided with the understanding that Lehman Brothers is not acting in a fiduciary capacity. Opinions expressed herein reflect the opinion of Lehman Brothers and are subject to change without notice. The products mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors. If an investor has any doubts about product suitability, he should consult his Lehman Brothers representative. The value of and the income produced by products may fluctuate, so that an investor may get back less than he invested. Value and income may be adversely affected by exchange rates, interest rates, or other factors. Past performance is not necessarily indicative of future results. If a product is income producing, part of the capital invested may be used to pay that income. © 2008 Lehman Brothers. All rights reserved. Additional information is available on request. Please contact a Lehman Brothers entity in your home jurisdiction.

Lehman Brothers policy for managing conflicts of interest in connection with investment research is available at www.lehman.com/researchconflictspolicy. Complete disclosure information regarding companies covered by Lehman Brothers Equity Research, including ratings, earnings per share forecasts and price targets contained in reports covering U.S. companies is available at www.lehman.com/disclosures.