

ITC Limited

Growth priced in

▼ Neutral

Previous: Overweight

ITC.BO, ITC IN

Price: Rs183.25

▼ Price Target: Rs196.00

Previous: Rs205.00

- **4Q09 earnings were 2% below our estimates** (though EBITDA was 5% ahead of estimates because of higher margins in the cigarette business and impressive growth in the paper and agri-foods business). We are also modestly cutting FY10 estimates by 2%.
- **We believe the key short-term risk to the stock is higher than expected 7% hike in excise taxes** when the budget is announced in July, which is likely given the precarious fiscal position. While it would likely be passed on, it would impact our volume growth assumptions of 3%. However, introduction of pictorial warnings on cigarette packs is unlikely to dampen consumption, in our view: 70% of cigarettes are sold in loose form anyway.
- **We work with an assumption of 13% EBITDA growth for the cigarette business.** As it accounts for over 80% of Group EBITDA, better performances from Paper and Agri are unlikely to lift profits, with the hotels business continuing to be a drag on growth. Overall growth is unlikely to surpass mid-teens.
- **We therefore downgrade the stock to Neutral:** Given its rich valuations (18x FY10E) and c20% premium to market multiples, we believe it will be difficult for ITC to outperform, especially in an environment where investors seek to add beta. We refrain from an Underweight because of ITC's stronger economic franchise, in our view. We reduce our sum-of-parts-based Mar'10 target price to Rs196 for the stock. Key upside risk to our target price and rating are marginal tax increases on cigarettes and lower than anticipated FMCG losses. Key downside risk is steep hike in excise duty for cigarettes and other legislative changes that impact cigarette demand.

India

Tobacco

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J.P. Morgan Securities (Asia Pacific) Limited

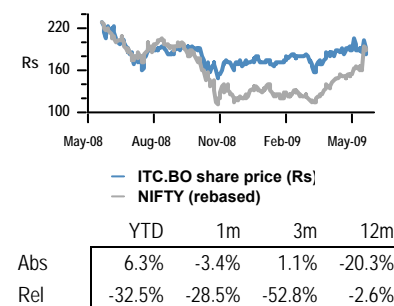
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J.P. Morgan India Private Limited

Price Performance



Reuters: ITC.BO, Bloomberg: ITC IN

Rs in millions, year-end March

	FY08	FY09E	FY10E	FY11E		
Net sales	139,475	153,778	172,403	194,420	52-week range (Rs)	132-232
Net profit	31,201	32,635	38,794	45,371	Market cap (Rs B)	694
EPS (Rs)	8.2	8.6	10.2	12.0	Market cap (US\$ B)	15
DPS (Rs)	3.5	3.7	4.0	5.0	Shrs outstanding (MM)	3772
Net sales growth (%)	15%	10%	12%	13%	Free float (%)	68
Net profit growth (%)	16%	5%	19%	17%	Avg daily value (Rs MM)	1086
EPS growth (%)	15%	5%	19%	17%	Avg daily value (US\$ MM)	23.1
ROE (%)	26%	24%	24%	24%	Avg dly volume (MM shs)	6.0
ROCE (%)	40%	37%	38%	38%	BSE sensex	13887
BVPS (Rs)	31.9	36.5	42.5	49.9	Exchange rate (Rs/US\$)	47.1
P/E (x)	22.3	21.3	18.0	15.4		
P/BV (x)	5.8	5.0	4.3	3.7	Performance	1 mth
EV/EBITDA (x)	14.4	13.1	11.1	9.4	Absolute (%)	
Dividend yield	1.9%	2.0%	2.2%	2.7%	Relative (%)	

Source: Bloomberg, Company reports and J.P. Morgan estimates. Note: Pricing as of May 22, 2009 close.

See page 10 for analyst certification and important disclosures, including non-US analyst disclosures.

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Q4FY09 results review

ITC reported net sales of Rs38.9bn (-1% y/y) and net earnings of Rs8.1bn (+10% y/y) during Q4FY09. Revenues and PAT were 6% and 2% below our estimates respectively. However EBITDA growth surprised on the upside (up 21% y/y and 5% ahead of our expectations) with margins expanding 590bp y/y on account of higher operating profit growth for the cigarette and agri business and lower than anticipated FMCG losses. Sales growth declined largely due to 50% decline in agri business revenues. Lower other income (-46% y/y) depressed overall earnings growth to 10% during the quarter.

Table 1: Quarterly income statement

Rs in mn

	Mar'08	Jun'08	Sep'08	Dec'08	Mar'09	Y/Y	Q/Q
Gross Income	60,097	59,589	58,439	59,172	58,707	-2%	-1%
Net Sales Turnover	39,344	38,997	37,633	38,333	38,918	-1%	2%
Change in Stock	531	(484)	(1,082)	(480)	810		
Raw Materials	17,914	18,519	16,567	15,651	14,968	-16%	-4%
Staff Cost	1,911	2,181	2,377	2,130	2,222	16%	4%
Other Expenditure	8,542	7,509	8,612	7,506	8,293	-3%	10%
Total Expenditure	28,897	27,726	26,473	24,806	26,291	-9%	6%
EBITDA	10,447	11,271	11,160	13,527	12,627	21%	-7%
Other Income	1,637	1,144	2,098	1,229	879	-46%	-29%
Depreciation	1,215	1,261	1,340	1,442	1,451.1	19%	1%
EBIT	10,869	11,154	11,919	13,314	12,055	11%	-9%
Interest	27	14.1	27.8	4.5	136.8	NM	NM
PBT	10,842	11,140	11,891	13,310	11,918	10%	-10%
Tax	3,485	3,653	3,864	4,277	3,828	10%	-11%
PAT	7,356	7,487	8,027	9,032	8,090	10%	-10%
Margin							
EBITDA Margin	26.6%	28.9%	29.7%	35.3%	32.4%		
Net Margin	18.7%	19.2%	21.3%	23.6%	20.8%		
% of Sales							
Cost of Goods	46.9%	46.2%	41.1%	39.6%	40.5%		
Staff Cost	4.9%	5.6%	6.3%	5.6%	5.7%		
Others	21.7%	19.3%	22.9%	19.6%	21.3%		
Tax as % of PBT	32.1%	32.8%	32.5%	32.1%	32.1%		
Growth YoY							
Net Sales	16.7%	18.4%	15.1%	11.1%	-1.1%		
Operating Profit	12.3%	0.0%	8.1%	12.8%	20.9%		
Net Profit	13.1%	-4.4%	19.7%	8.7%	10.0%		

Source: Company reports.

Table 2: Segment wise quarterly trends

Rs mn

	Mar'08	Jun'08	Sep'08	Dec'08	Mar'09	Y/Y	Q/Q
Segment Revenues							
FMCG Cigarettes	35,830	36,361	36,282	39,015	39,493	10%	1%
FMCG Others	7,384	6,936	7,593	7,223	8,388	14%	16%
Total FMCG	43,214	43,297	43,875	46,238	47,881	11%	4%
Hotels	3,393	2,594	2,490	2,705	2,413	-29%	-11%
Agri Business	10,781	18,345	8,641	6,215	5,259	-51%	-15%
Paper and Packagin	6,197	6,517	7,533	6,699	7,470	21%	12%
Others Total	20,371	27,457	18,663	15,620	15,143	-26%	-3%
Total Segment Revenue	63,585	70,753	62,538	61,858	63,024	-1%	2%
Segment EBIT							
FMCG Cigarettes	8,701	9,614	10,069	11,341	10,814	24%	-5%
FMCG Others	(1,179)	(1,226)	(1,166)	(1,270)	(1,173)	-1%	-8%
Total FMCG	7,522	8,388	8,903	10,071	9,641	28%	-4%
Hotels	1,428	853	687	911	711	-50%	-22%
Agri Business	370	765	764	502	531	43%	6%
Paper and Packagin	1,227	1,234	1,222	1,111	1,519	24%	37%
Others Total	3,025	2,852	2,674	2,523	2,761	-9%	9%
EBIT Margin							
FMCG Cigarettes	24.3%	26.4%	27.8%	29.1%	27.4%		
FMCG Others	-16.0%	-17.7%	-15.3%	-17.6%	-14.0%		
Total FMCG	17.4%	19.4%	20.3%	21.8%	20.1%		
Hotels	42.1%	32.9%	27.6%	33.7%	29.5%		
Agri Business	3.4%	4.2%	8.8%	8.1%	10.1%		
Paper and Packagin	19.8%	18.9%	16.2%	16.6%	20.3%		
Others Total	14.8%	10.4%	14.3%	16.2%	18.2%		
Total EBIT	16.6%	15.9%	18.5%	20.4%	19.7%		
Segment Revenue Y/Y Growth							
FMCG Cigarettes	8.8%	5.7%	10.9%	10.5%	10.2%		
FMCG Others	50.3%	27.9%	30.1%	11.7%	13.6%		
Total FMCG	14.2%	8.7%	13.8%	10.7%	10.8%		
Hotels	11.5%	17.3%	10.1%	-13.7%	-28.9%		
Agri Business	28.1%	32.3%	16.7%	-6.2%	-51.2%		
Paper and Packagin	16.2%	23.9%	22.6%	10.9%	20.6%		
Others Total	21.3%	28.7%	18.0%	-1.2%	-25.7%		
Total Segment Revenue	16.4%	15.7%	15.0%	7.5%	-0.9%		

Source: Company reports.

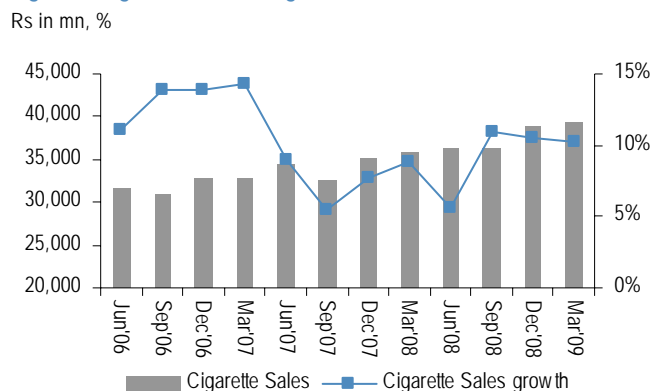
Cigarette business - Margins surprise on upside

Conversions from non-filter to filter remained healthy at 70-75% as seen in previous three quarters. Volume declined by 3-3.5% y/y during the quarter and overall volume decline for the full year was in similar range. Sales grew 10% y/y during the quarter aided by price growth of 13% during the quarter, of which 6-7% was on account of weighted average price increases for cigarettes and remaining due to improved product mix. Margins expanded significantly by 310bp y/y on account of shift towards filter cigarettes and price hikes.

Company has undertaken 10% price hike for Goldflake Kings brand (estimated contribution of 7-8% to overall sales) and 4% price hike for Goldflake Regular (estimated contribution of 25% to overall sales). As per recent government notification pictorial warnings have been made compulsory from May 31st on tobacco products in India. Management indicated that company may have to take one time hit of Rs200-250mn on account of packaging costs which is likely to be reflected in Q1FY10 itself and some part of the same has been accounted for in Q4FY09 as well. We believe impact on demand should be minimal considering nearly 65-70% of cigarette sales in India are loose. Also experience in other international markets indicates that impact of warnings on consumption levels has not been significant.

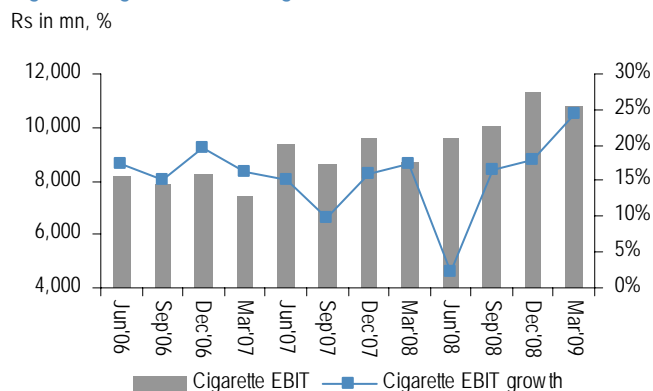
We estimate volume growth of 3% during FY10 and build in 80bp expansion in EBIT margins driven by realisation improvement. We are building in 7% excise duty hike during FY10 and estimate EBIT for this division to grow 13% and 12%, respectively, during FY10 and FY11.

Figure 1: Cigarette sales and growth trends



Source: Company reports.

Figure 2: Cigarette EBIT and growth trends



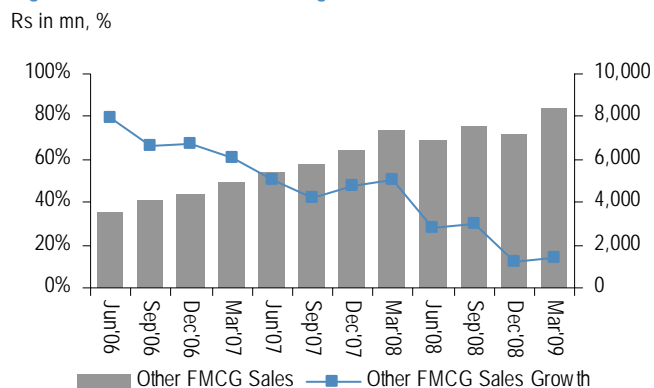
Source: Company reports.

Other FMCG – Moderating losses; plans to enter a new category this fiscal

While top line growth for the other FMCG division was in line with our expectations, we were positively surprised by lower other FMCG EBIT losses at Rs117mn, declining 8% sequentially. Company's intentional strategy to move out of low margin staples and biscuit variants and increased focus on cost controls is helping reduce losses for this segment. Sales growth for the overall division improved marginally on a sequential basis to 14% y/y. The quantum of EBIT losses for this division are likely to decline in coming quarters as benefits of declining raw material prices and efficiencies of scale (particularly for the personal care segment) kick in. Management indicated that they expect these losses to be 20% lower in FY10 and are planning to enter one new category during the current fiscal.

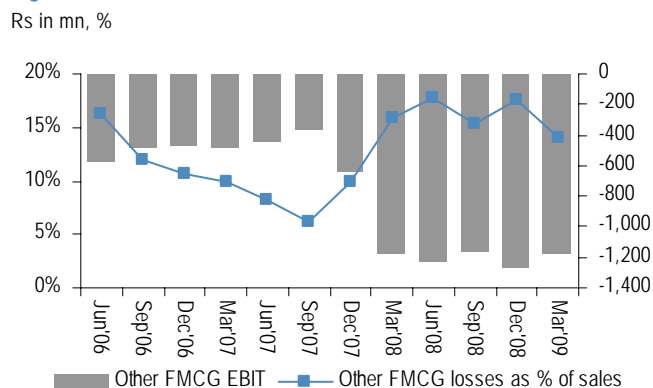
Performance of personal care range is tracking management expectations as it continues to extend its presence across the nation. In coming quarters we expect company to build scale in existing categories via launch of more variants and extensions of current brand portfolio and focus on improving share of high margin products.

Figure 3: Other FMCG sales and growth trends



Source: Company reports.

Figure 4: Other FMCG EBIT trends

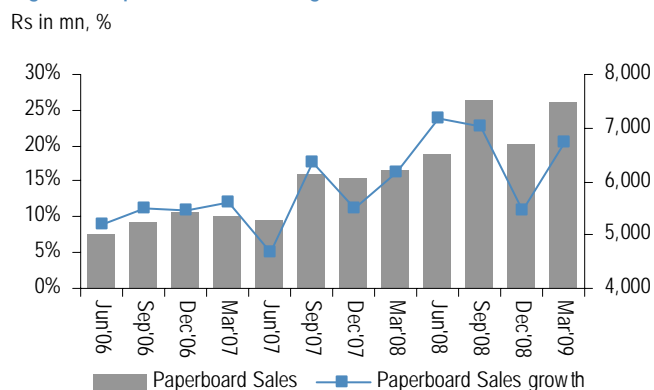


Source: Company reports.

Paperboards – Higher capacity utilization gains to benefit

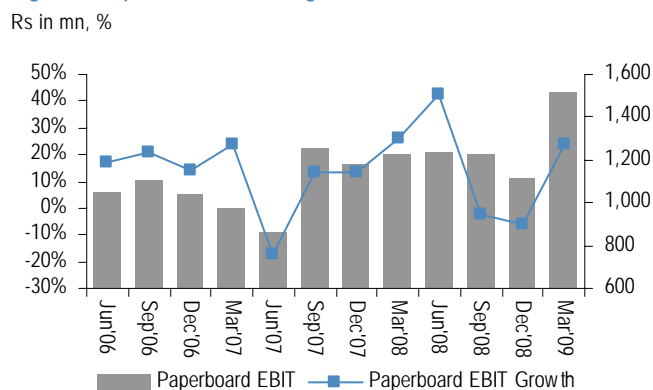
Performance of paper division improved sequentially as benefits of higher capacity utilization at recently commissioned new pulp mill facilities kicked in. The division registered 21% y/y and 24% y/y growth in net sales and EBIT during Q4FY09 with margins expanding 50bp y/y.

Figure 5: Paperboard sales and growth trends



Source: Company reports.

Figure 6: Paperboard EBIT and growth trends

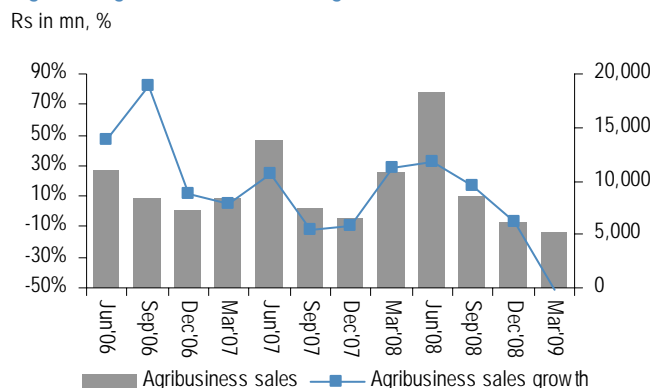


Source: Company reports.

Agri Business – High tobacco realisations offset major decline in soya sales

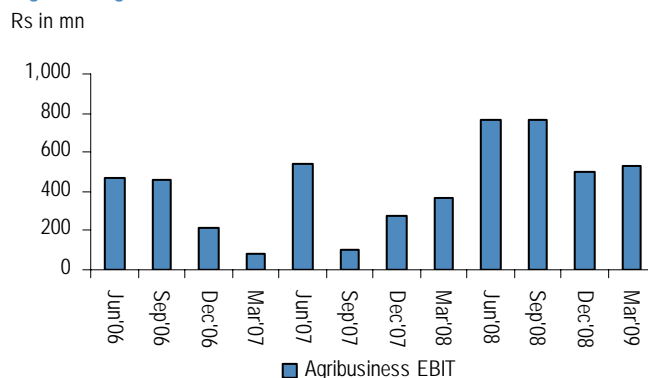
Lower sales of soya and rationalization of agri commodity portfolio led to major 51% decline in revenues for this division during the quarter. However, steep inflation in leaf tobacco helped EBIT grow 43% y/y. Leaf tobacco prices are up 70-80% y/y on account of low global supplies (particularly in Brazil and Zimbabwe) amidst increased demand from international tobacco majors.

Figure 7: Agri-business sales and growth trends



Source: Company reports.

Figure 8: Agri-business EBIT trends

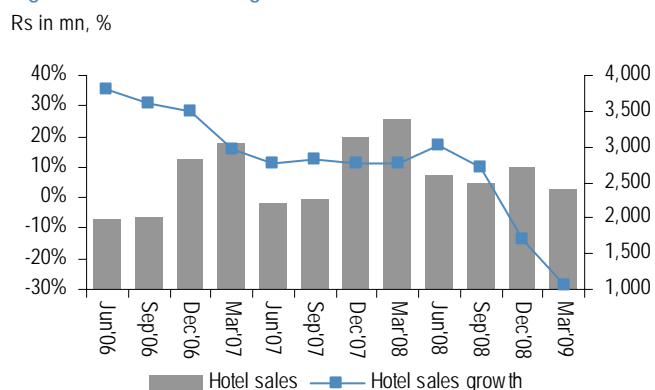


Source: Company reports.

Hotels – Disappointing performance; Likely to be a drag in FY10 as well

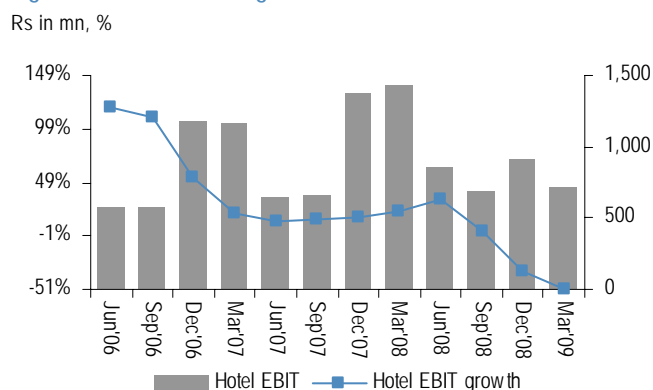
We were significantly disappointed by performance of hotel business which registered 29% y/y decline in revenues and nearly 50% decline in EBIT during the quarter. Lower occupancy rates and average room rates contributed to such significant downfall. As per management, Q1FY10 is likely to witness similar slowing trends and it expects 2HFY10 to be relatively better. For the full year FY10 we are building in flat revenue and EBIT growth considering weakening demand trends for this business.

Figure 9: Hotel sales and growth trends



Source: Company reports.

Figure 10: Hotel EBIT and growth trends



Source: Company reports.

Valuation and target price

We are reducing our earnings estimates for FY10 and FY11 by 2% each as we build in slowing top line growth for other FMCG and hotel business. We also reduce our margin assumptions for hotel business. Accordingly, we lower our sum of parts based Mar'10 target price to Rs196 (earlier Rs205). We downgrade our rating from Overweight to Neutral given ITC's rich valuations (18x FY10 P/E) and c20% premium to market multiples. We believe it will be difficult for ITC to outperform, especially in an environment where investors seek to add beta.

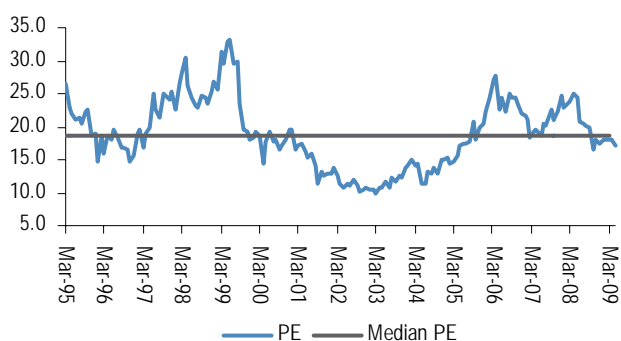
Table 3: Sum-of-parts valuation for ITC

	Methodology	Multiple (X)	Value (X)	Per Share	% to total
FMCG Cigarettes	EV/EBITDA	10.0x	545,512	144	74%
FMCG Others	EV/Sales	1.5x	60,708	16	8%
Hotel	EV/EBITDA	7.0x	35,895	9	5%
Paper and Packaging	EV/EBITDA	6.0x	58,774	16	8%
Agri-Business	EV/EBITDA	3.0x	11,382	3	2%
EV			712,271	188	96%
Net Cash			28,035	7	4%
Equity Value			740,305	196	100%

Source: J.P. Morgan estimates.

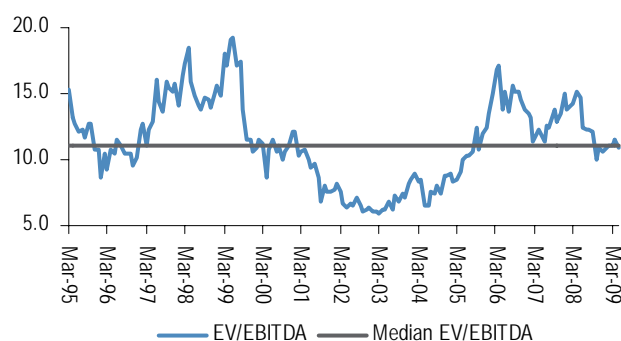
Key upside risk to our target price and rating are marginal tax increases on cigarettes and lower than anticipated FMCG losses. Key downside risk is steep hike in excise duty for cigarettes, any business diversification that is substantially dilutive of earnings and any legislative changes that impact cigarette demand.

Figure 11: Rolling 1-yr forward P/E (x) of ITC



Source: Bloomberg, Company reports and J.P. Morgan estimates

Figure 12: Rolling 1-yr EV/EBITDA (x) of ITC



Source: Bloomberg, Company reports and J.P. Morgan estimates

Table 4: Global tobacco valuation

	Share price	Market cap (\$mn)	P/E		Div yield		EV/EBITDA	
			2009E	2010E	2009E	2010E	2009E	2010E
International								
British American Tobacco	1667	46,985	11.3	10.2	5.8%	6.4%	8.8	8.2
Imperial**	1615	23,077	10.0	9.1	4.6%	5.4%	8.7	8.0
PMI	43	88,959	14.5	13.1	5.1%	5.1%	10.2	9.6
Swedish Match	124	4,160	12.9	11.9	3.7%	4.0%	9.6	9.2
US								
Altria	17	34,395	9.5	9.1	7.8%	7.9%	5.7	5.6
Lorillard	68	11,657	12.3	12.1	5.6%	5.8%	6.9	6.8
Reynolds American	39	11,515	9.1	8.7	8.7%	8.7%	6.3	6.2
Asia								
Japan Tobacco	272900	27,705	8.9	7.3	2.2%	3.2%	6.0	5.2
KT&G	69400	7,371	10.2	11.3	3.9%	3.9%	7.9	8.9
			25%	33%			35%	40%
Emerging Markets								
BAT Malaysia	42	3,400	14.2	13.8	6.4%	6.5%	10.1	9.9
ITC	182	14,581	17.4	14.9	2.5%	3.0%	10.8	9.3
Souza Cruz	49	7,340	11.0	10.0	8.7%	9.3%	7.4	6.6

Source: J.P. Morgan estimates.

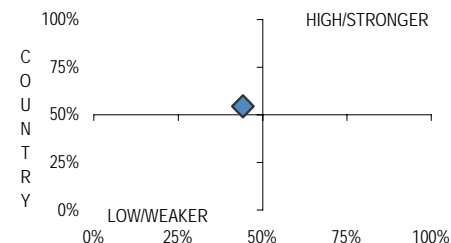
All Data As Of 22-May-09

Q-Snapshot: ITC Ltd.

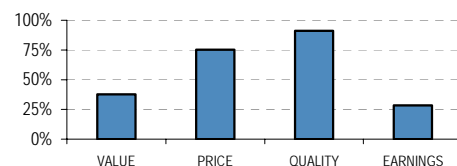
Quant Return Drivers (a Score >50% indicates company ranks 'above average')

Score 0% (worst) to 100% (best)	vs Country	vs Industry	Raw Value
Value			
P/E Vs Market (12mth fwd EPS)	30%	34%	1.2x
P/E Vs Sector (12mth fwd EPS)	52%	62%	0.9x
EPS Growth (forecast)	58%	41%	11.2%
Value Score	38%	34%	
Price Momentum			
12 Month Price Momentum	60%	47%	-18.5%
1 Month Price Reversion	98%	84%	-3.4%
Momentum Score	75%	58%	
Quality			
Return On Equity (forecast)	80%	79%	26.5%
Earnings Risk (Variation in Consensus)	98%	96%	0.05
Quality Score	91%	88%	
Earnings & Sentiment			
Earnings Momentum 3mth (risk adjusted)	68%	71%	14.6
1 Mth Change in Avg Recom.	68%	64%	0.00
Net Revisions FY2 EPS	4%	10%	-100%
Earnings & Sentiment Score	28%	32%	
COMPOSITE Q-SCORE* (0% To 100%)	55%	44%	

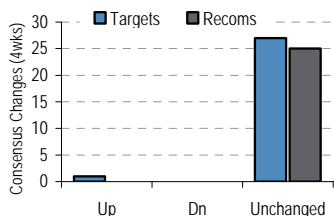
J.P. Morgan Composite Q-Score



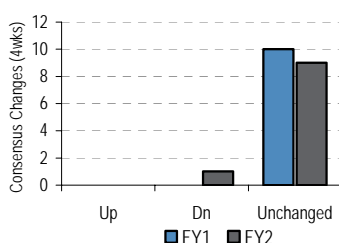
INDUSTRY
Quant Return Drivers Summary (vs Country)



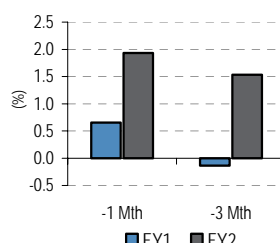
Targets & Recommendations**



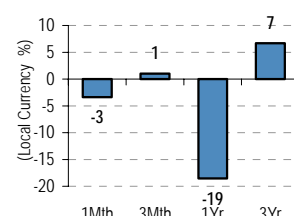
EPS Revisions**



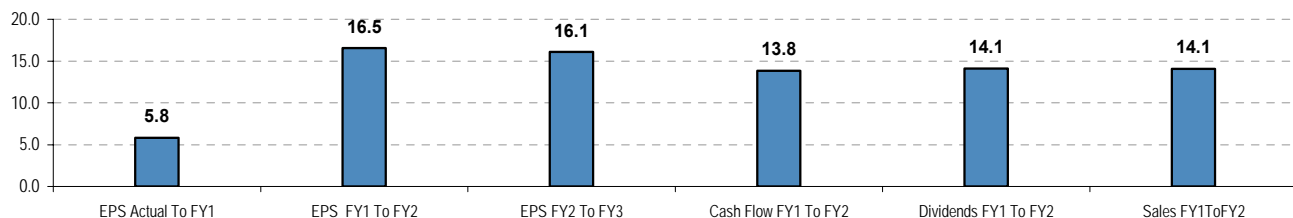
EPS Momentum (%)



Historical Total Return (%)



Consensus Growth Outlook (%)



Closest in Country by Size (Consensus. ADV = average daily value traded in US\$m over the last 3 mths)

Code	Name	Industry	USD MCAP	ADV	PE FY1	Q-Score*
500112-IN	State Bank of India	Regional Banks	23,655	20.46	11.0	47%
500103-IN	Bharat Heavy Electricals Ltd.	Electrical Products	20,905	8.20	29.7	68%
500209-IN	Infosys Technologies Ltd.	Information Technology Services	18,392	5.54	15.0	41%
500510-IN	Larsen & Toubro Ltd.	Trucks/Construction/Farm Machinery	16,653	13.96	25.5	56%
532174-IN	ICICI Bank Ltd.	Regional Banks	16,515	30.58	19.0	27%
500875-IN	ITC Ltd.	Tobacco	14,748	1.95	20.5	55%
500113-IN	Steel Authority of India Ltd.	Steel	14,290	4.94	11.9	27%
532540-IN	Tata Consultancy Services Ltd.	Information Technology Services	13,876	3.02	12.2	34%
532712-IN	Reliance Communications Ltd.	Major Telecommunications	13,320	12.85	14.0	27%
500010-IN	Housing Development Finance Corp. Ltd.	Finance/Rental/Leasing	13,157	9.89	23.2	46%
532743-IN	Reliance Petroleum Ltd.	Oil Refining/Marketing	12,649	5.38	10.1	31%

Source: Factset, Thomson and J.P. Morgan Quantitative Research. For an explanation of the Q-Snapshot, please visit <http://jpmorgan.hk.acrobat.com/qsnapshot/>
Q-Snapshots are a product of J.P. Morgan's Global Quantitative Analysis team and provide quantitative metrics summarized in an overall company 'Q-Score.'
Q-Snapshots are based on consensus data and should not be considered as having a direct relationship with the J.P. Morgan analysts' recommendation.
* The Composite Q-Score is calculated by weighting and combining the 10 Quant return drivers shown. The higher the Q-Score the higher the one month expected return. On a 14 Year back-test the stocks with the highest Q-Scores have been shown (on average) to significantly outperform those stocks with the lowest Q-Scores in this universe. ** The number of up, down and unchanged target prices, recommendations or EPS forecasts that make up consensus.

Summary Financials

Rs in mn, year end Mar

Profit and Loss statement					Cash flow statement				
	FY08A	FY09E	FY10E	FY11E		FY08A	FY09E	FY10E	FY11E
Net sales	139,475	153,778	172,403	194,420	EBIT	43,278	47,412	55,456	64,604
% change Y/Y	15%	10%	12%	13%	Depreciation	-4,385	-5,448	-5,619	-6,106
EBITDA	47,662	52,861	61,074	70,710	Change in WC	-4,315	-7,070	-6,039	-7,049
% change Y/Y	14%	11%	16%	16%	Taxes	-14,135	-15,617	-18,256	-21,351
EBITDA Margin (%)	34%	34%	35%	36%	Interest	-46	-183	-165	-148
EBIT	43,278	47,412	55,456	64,604	Others	6,832	11,920	12,997	14,479
% change Y/Y	13%	10%	17%	16%	Cash flow from operations	27,230	31,014	38,374	44,428
EBIT Margin (%)	31%	31%	32%	33%	Capex	-22,461	-14,346	-16,395	-16,392
Interest expense	-46	-183	-165	-148	Free cash flow	4,769	16,668	21,978	28,036
Earnings before tax	45,718	48,252	57,050	66,722	Equity raised/ (repaid)	446	0	0	0
% change Y/Y	16%	6%	18%	17%	Debt raised/ (repaid)	136	0	0	0
Tax	(14,517)	(15,617)	(18,256)	(21,351)	Other	1,506	0	-1	1
as % of EBT	-32%	-32%	-32%	-32%	Dividends paid	-11,590	-15,226	-16,096	-17,410
Net Income	31,201	32,635	38,794	45,371	Change in cash	-4,734	1,443	5,882	10,626
% change Y/Y	16%	5%	19%	17%	Beginning cash	31,326	26,592	28,035	33,917
Shares Outstanding	3783	3783	3785	3787	Ending cash	26,592	28,035	33,917	44,543
EPS (Adjusted)	8.2	8.6	10.2	12.0	DPS	3.5	3.7	4.0	5.0
% change Y/Y	15%	5%	19%	17%	Ratio Analysis				
Balance sheet					%	FY08A	FY09E	FY10E	FY11E
Cash and cash equivalents	26,592	28,035	33,917	44,543	EBITDA margin	34%	34%	35%	36%
Accounts receivable	7,369	11,424	13,462	15,810	EBIT margin	31%	31%	32%	33%
Inventories	40,505	45,207	51,884	59,469	Net profit margin	22%	21%	23%	23%
Others	16,616	16,616	16,616	16,616	SG&A/sales	15%	16%	15%	15%
Current assets	91,083	101,282	115,878	136,438	Sales growth	15%	10%	12%	13%
Investments	8,456	8,456	8,456	8,456	Net profit growth	16%	5%	19%	17%
Net fixed assets	72,957	81,854	92,631	102,917	EPS growth	15%	5%	19%	17%
Total assets	172,495	191,592	216,964	247,811	Interest coverage (x)	NM	NM	NM	NM
Liabilities					Net debt to total capital	Net Cash	Net Cash	Net Cash	Net Cash
Payables	27,397	29,084	31,759	34,644	Net debt to equity	Net Cash	Net Cash	Net Cash	Net Cash
Others	16,926	16,926	16,926	16,926	Sales/assets	0.8	0.8	0.8	0.8
Total current liabilities	44,323	46,010	48,685	51,570	Assets/equity	3.3	3.6	3.9	4.2
Total Loans	2,144	2,144	2,144	2,144	ROE	26%	24%	24%	24%
Other liabilities	5,451	5,451	5,451	5,451	ROCE	40%	37%	38%	38%
Total liabilities	51,918	53,606	56,280	59,166					
Shareholders' equity	120,577	137,986	160,684	188,645					
BVPS	31.9	36.5	42.5	49.9					

Source: Company reports and J.P. Morgan estimates.

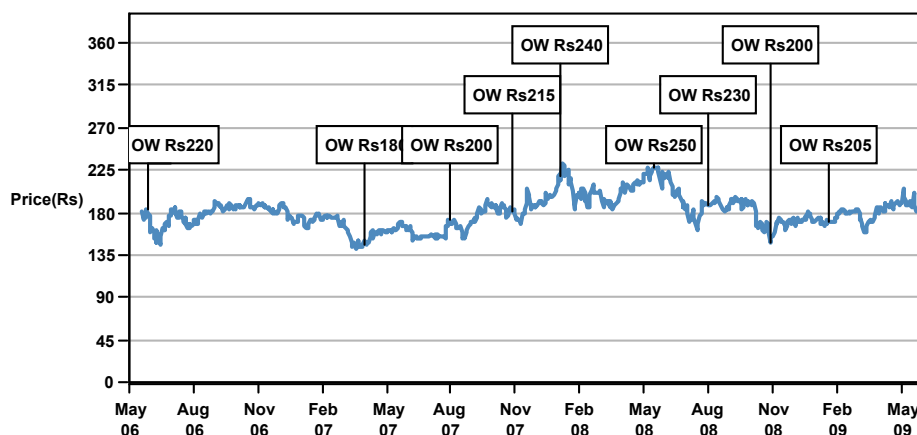
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ITC Limited (ITC.BO) Price Chart



Date	Rating	Share Price (Rs)	Price Target (Rs)
27-May-06	OW	183.25	220.00
30-Mar-07	OW	146.75	180.00
29-Jul-07	OW	171.80	200.00
28-Oct-07	OW	180.80	215.00
02-Jan-08	OW	217.60	240.00
15-May-08	OW	226.65	250.00
31-Jul-08	OW	187.80	230.00
26-Oct-08	OW	149.05	200.00
19-Jan-09	OW	170.55	205.00

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
 Break in coverage Mar 03, 2004 - Sep 17, 2004. This chart shows J.P. Morgan’s continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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