Company report

Consumer Brands and Retail
Tobacco
Equity – India

HSBC Global Research

ITC

VAT sensitivity analysis

- **Our analysis of the potential impact of VAT on ITC, reveals a possible 6% negative impact on FY08e EPS. If VAT were to be imposed at 12.5% our target price would fall 7% to INR195**
- **The re-emergence of possibility of VAT being imposed on tobacco from April 2007 is likely to weigh upon ITC's stock price short-term. But, our analysis of the historical trade off between price and volume growth implies that absolute sales decline is unlikely, even in the event of VAT imposition**
- **In the event of VAT imposition, our price target would emerge at INR195 ie we would still rate ITC at Overweight on a 12-month view. We maintain our INR210 per share target price and Overweight rating**

Overweight

Target price	210
Share price	160
Potential total return (%)	33.2

Year to March	2007e	2008e	2009e
HSBC EPS	7.30	8.80	10.38
HSBC PE	21.9	18.2	15.4

Performance	1M	3M	12M
Absolute (%)	-10.6	-12.2	-4.0
Relative^ (%)	-2.6	-7.7	-25.1

Pandora's VAT Box reopens

A Bloomberg article on 1 March describes a telephone interview with Mr Ravi Mittal, Commissioner of Commercial Taxes and Secretary to the Government of Bihar which reopens the Pandora's Box on VAT (see our last research report on ITC, *VAT danger allayed: Upgrade to Overweight* 1 March 2007). States may widen the VAT net to include tobacco to compensate for a reduction in the central sales tax rate from 4% to 3% in the recent Union Budget. This would be implemented "Only when central government direction comes." Since the reduction in central sales tax will be implemented on 1 April, we believe that it is likely that the central government will announce a decision on this issue over the next few weeks.

We think that it would be premature to change our target price based on this information, as no definite announcement has yet been made. However, we present a sensitivity analysis of the stock price to the introduction of VAT, which implies that if VAT were to be applied to tobacco at 12.5%, our FY08e EPS would decline by 6%.

In the event of VAT imposition, our target price would be negatively affected by 7%, to INR195 per share ie all else remaining the same, our 12-month rating on ITC would remain Overweight, and we would be looking to accumulate the stock on any weakness caused by this event.

Index^	BOMBAY SE IDX
Index level	12,379
RIC	ITC.BO
Bloomberg	ITC IN

Source: HSBC

Enterprise value [CURm]	570,878
Free float (%)	44.25
Market cap (USDm)	14,044
Market cap [CURm]	620,975

Source: HSBC

6 March 2007

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Financials & valuation

Financial statements

Year to	03/2006a	03/2007e	03/2008e	03/2009e
Profit & loss summary (INRm)				
Revenue	97,905	123,278	150,400	178,976
EBITDA	33,274	40,698	50,535	61,515
Depreciation & amortisation	-3,323	-3,637	-4,548	-5,272
Operating profit (EBIT)	29,950	37,061	45,988	56,242
Net interest	-119	-18	0	0
PBT	32,692	40,165	48,432	58,687
Taxation	-9,888	-12,770	-15,398	-19,719
Net profit	22,804	27,395	33,034	38,968
Cash flow summary (INRm)				
Cash flow from operations	22,832	27,727	35,438	43,559
Capex	-6,006	-7,832	-13,501	-14,501
Dividends	-11,195	-11,829	-12,674	-14,786
Change in net debt	-9,258	-8,066	-9,263	-14,271
FCF equity	13,889	20,712	19,492	26,613
Balance sheet summary (INRm)				
Tangible fixed assets	44,051	48,246	57,199	66,428
Current assets	51,619	67,625	86,545	110,500
Cash & others	8,558	15,427	24,690	38,962
Total assets	133,072	153,273	181,146	214,330
Operating liabilities	21,890	31,098	37,860	44,984
Net debt	-7,361	-15,427	-24,690	-38,962
Shareholders funds	90,615	106,181	126,541	150,723
Invested capital	65,222	69,346	81,194	92,982

Ratio, growth and per share analysis

Year to	03/2006a	03/2007e	03/2008e	03/2009e
Y-o-y % change				
Revenue	28.2	25.9	22.0	19.0
EBITDA	19.2	22.3	24.2	21.7
Operating profit	20.8	23.7	24.1	22.3
PBT	22.3	22.9	20.6	21.2
EPS	-17.5	20.1	20.6	18.0
Ratios (%)				
Revenue/IC (x)	1.6	1.8	2.0	2.1
ROIC	34.2	37.6	41.7	42.9
ROE	26.9	27.8	28.4	28.1
ROA	18.3	19.1	19.8	19.7
EBITDA margin	34.0	33.0	33.6	34.4
Operating profit margin	30.6	30.1	30.6	31.4
EBITDA/net interest (x)	278.9	2,215.1	NA	NA
Net debt/equity	-8.1	-14.5	-19.5	-25.8
Net debt/EBITDA (x)	-0.2	-0.4	-0.5	-0.6
Per share data (INR)				
EPS reported (fully diluted)	6.07	7.30	8.80	10.38
DPS	2.65	2.80	3.00	3.50
NAV	24.14	28.29	33.72	40.16

DCF analysis

HSBC assumptions		DCF, comprising	
Beta	0.76	Value of enterprise	784,009
Cost of equity	11.5	Value of non core assets	35,170
WACC	11.5	Value of equity	819,179

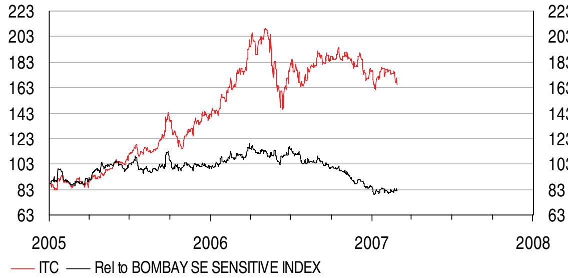
DCF sensitivity and valuation range

Cost of capital vs fade period	10 years	15 years	20 years
9.5%	275	307	339
10.5%	234	256	278
11.5%	202	218	233
12.5%	177	188	199
13.5%	156	165	172

Valuation data

Year to	03/2006a	03/2007e	03/2008e	03/2009e
EV/sales	5.9	4.6	3.7	3.1
EV/EBITDA	17.4	14.0	11.1	8.9
EV/IC	8.9	8.2	6.9	5.9
PE	26.3	21.9	18.2	15.4
P/NAV	6.8	5.8	4.9	4.1
FCF yield (%)	2.4	3.5	3.3	4.5
Dividend yield (%)	1.7	1.8	1.9	2.2

Price relative



Source: HSBC

Note: price at 13.00 March 5 2007

HSBC

Volume or price growth?

- History shows high negative correlation between increases in ITC's tobacco ASP and decreases in sales volumes
- Our sensitivity analysis suggests that sales volumes would still grow 4.5% in the event of a price hike of 8.75% (which would offset VAT imposition of 12.5% plus the 5% hike in excise duty)
- In the event of VAT imposition, we still estimate a 12-month total potential return of 23.8% ie our rating would remain Overweight

Our analysis of ITC's tobacco division's historical average selling price (ASP) hikes and sales volumes shows that there is a high negative correlation (-0.87) between increases in ASP and decreases in volumes.

Therefore, the company has to consider a trade-off between increasing prices and losing sales volumes, or restricting price increases to protect/increase sales volumes. The table below shows percentage changes in ASP and volumes.

ITC guide that the decision to raise ASPs is based on many factors, such as:

- The price ladder: ITC has a portfolio of brands that are carefully managed at different price points. Price increases have to be taken in such a way as to keep the ladder intact, ie the price differential between brands has to be kept relatively stable
- Demand elasticity in different geographical regions while keeping prices uniform across India
- Cost inflation, mainly from tax hikes
- The consumer's ability to absorb price increases based on macro-economic factors such as per capita income levels, GDP growth rate, etc

The last time ITC put through major price increases (in FY02) of 14.1% on the back of an excise duty increase of 15%, volumes dropped by 8.4%. We believe that there is market concern that if VAT is introduced, the total tax incidence of 17.5% (excise duty of 5% plus VAT of 12.5%) would be the highest ever, and this may trigger a sales volume decline similar to that witnessed in FY02.

ITC: Cigarettes volume growth vs price growth

	FY01	FY02	FY03	FY04	FY05	FY06
ASP growth	10.1%	14.1%	4.9%	2.1%	1.2%	4.5%
Volume growth	0.5%	-8.4%	4.2%	3.1%	7.1%	8.4%

Note: ASP calculated as gross sales divided by number of sticks sold
Source: HSBC

ITC: Impact of VAT on HSBC's current estimates

	FY08e			FY09e		
	Base case	VAT 12.5%	Variance	Base case	VAT 12.5%	Variance
Price growth (total)	5.0%	8.8%	75.0%	5.0%	5.0%	0.0%
Price growth (after of tax increases)	2.5%	0.0%	-100.0%	2.5%	2.5%	0.0%
Volume growth	8.0%	4.5%	-43.8%	7.5%	6.5%	-13.3%
Net Sales (cigarettes division, INRm)	69420	65532	-5.6%	76492	71536	-6.5%
EBIT (cigarettes division, INRm)	34710	31701	-8.7%	39011	35085	-10.1%
EPS (INR)	8.80	8.25	-6.2%	10.38	9.69	-6.7%

Source: HSBC estimates

We believe that these fears are unlikely to be realised due to the following reasons:

- The price increase in FY02 of 14.1% was more than required to set off inflation on taxes. Since excise duties account for about 50% of tobacco gross revenues, average selling price (ASP) increases need be only half that of tax increases to neutralise the effect completely. In FY02 ITC put through an extra price increase which was a conscious decision based on the company's analysis of the price to volume trade-off. We believe that ITC deliberately increased ASP more than necessary as natural volume growth was sluggish, in an attempt to maximise future revenues

- The current 5% increase in excise duties would require a 2.5% increase in average selling prices and since VAT would most likely be imposed net of excise duties, a 12.5% duty on VAT would be offset by a 6.25% increase in ASP. The total ASP increase necessary in order to remain neutral would therefore be 8.75%, much lower than the 14.1% implemented in FY02. We believe that ITC would not want to endanger the volume growth story by introducing price increases any more than necessary, limiting price increases to 9%, if VAT were to be imposed

- Based on our study of ASP vs volume growth, volume growth does not become negative even with a 10% ASP increase. Moreover, the Indian economy is in a much better state compared to the recessionary environment in 2001-02. Average salary growth is in excess of 12% (Source: The Times of India) and nominal GDP is growing by 15% (GDP growth rate of 9% and inflation at 6%). We believe that the cigarette market is in a better position to absorb a price increase than it was in 2002

VAT effect scenario analysis

We start off from a base case scenario (without VAT imposition) where we assume an ASP growth of 5% (including 2.5% from increase in excise duty) and volume growth of 8.0% for FY08e, thus net sales increase for cigarettes of 10.7%.

With the introduction of VAT at 12.5%, we assume ASP growth of 8.75% (all price growth would go to cover tax hikes) and volume growth to drop to 4.5%. This would affect our current FY08e EBIT forecast for ITC's tobacco division by -8.7%. Our current FY08e EPS estimate would decline 6.2% from INR8.80 to INR8.25.

HSBC

ITC: Impact of volume and price growth on HSBC's EPS estimates

Price growth	Volume +2.5%	Volume +3.5%	Volume +4.5%	Volume +5.5%	Volume +6.5%
6.75%	-12.6%	-11.6%	-10.6%	-9.6%	-8.6%
7.75%	-10.5%	**-9.4%**	**-8.4%**	**-7.4%**	-6.3%
8.75%	-8.3%	**-7.3%**	**-6.2%**	**-5.2%**	-4.1%
9.75%	-6.2%	**-5.1%**	**-4.0%**	**-2.9%**	-1.9%
10.75%	-4.0%	-2.9%	-1.8%	-0.7%	0.4%

Source: HSBC estimates

For FY09e we assume y-o-y ASP growth of 5% (unchanged from base case) and volume growth to be affected by -100bps. Our FY09e EBIT forecast for ITC's tobacco division would be negatively impacted by 10.1% and our current FY09e EPS estimate would decline by 6.7%.

From FY10e onwards, we assume y-o-y ASP growth and volume growth percentages to be in line with our current base case, although future EPS never recovers to our current estimates due to a lower base.

The table above shows the impact on ITC's FY08e EPS of different levels of tobacco ASP and sales volume growth, compared to our current base case scenario, according to our model.

Potential price target impact

Based on our scenario of 6.2% FY08e EPS decline if VAT were to be imposed, we estimate that there could be a downside of 7.1% on our one-year target price to INR195, from INR210 currently. All else remaining equal, our valuation would be affected as follows:

- Our PE based target price could decline 9.9%, from INR202 to INR182. This is derived by multiplying the EPS of INR8.25 under this scenario by a PE multiple of 22x (we believe that a compression of our target PE multiple from 23x to 22x would be justified as a result of sustained EPS decline due to VAT imposition)
- Our DCF fair value declines only by 4.6%, from INR218 to INR208 per share, as the effect of VAT reduces the further out we value the company, and also because other divisions increase their share of company revenues
- Blending our revised PE multiple / DCF fair values together would yield a target price of INR195 ie a decrease of 7.1%, in the event of VAT imposition

This would result in a 12-month total potential return of 23.8% (21.9% upside to the price target plus 1.9% FY08e dividend yield) and our rating would remain Overweight.

Valuation, rating and risk assessment

- Our DCF / PE multiple valuation drives a price target of INR210, representing 31.3% potential absolute return
- Including dividend yield indicates a 33.2% total return potential on a 12-month view and we retain our Overweight rating
- If VAT were to be imposed there may be a violent negative short-term market reaction, but this may provide a buying opportunity

Valuation and rating

Our current valuation range of INR202-218 is driven by PE multiple and DCF valuation methodologies:

1. PE multiple approach

Given 71% EPS growth FY06-09e, and the exciting prospects for ITC's non-tobacco FMCG businesses, we are comfortable applying a PE multiple of 23x, as per our previous valuation (see our last research report ITC: *VAT danger allayed: Upgrade to Overweight* 1 March 2007) to our FY08e EPS of INR8.80, to arrive at a PE multiple-based fair value of INR202 per share.

2. DCF approach

ITC: DCF sensitivity and valuation range

WACC vs fade period	10 years	15 years	20 years
9.5%	275	307	339
10.5%	**234**	**256**	**278**
11.5%	**202**	**218**	**233**
12.5%	**177**	**188**	**199**
13.5%	156	165	172

A DCF analysis (WACC 11.5%, three-stage DCF ending in 2045) yields a fair value of INR218. Our DCF sensitivity is shown in the table below.

Target price and rating

We take the average of our PE multiple and DCF valuation methodologies to arrive at our one-year price target of INR210 per share. At our target price, the stock would trade on a FY09e PE of 20.2x.

Our one-year price target represents 31.3% absolute upside, plus an anticipated 1.9% FY08e dividend yield, for a one-year total potential return of 33.2%. We retain our Overweight rating for ITC.

Risk assessment

We believe that the main risks to our Overweight rating are:

- ITC is investing in building new hotels in Bangalore, Chennai and Hyderabad. None of these hotels will be up before December 2008. It is possible that with over 20 hotels being planned, ITC's hotels may open into a more adverse industry environment, with rooms in oversupply. However, we believe that the quality of ITC's properties and the sustainability of its food and beverages business will insulate ITC against the adverse impact of any negative cycle
- The profitability of the paper business is dependent on pulp prices and the availability of power. However, ITC has set up a 100,000 tonne pulp mill that would to some extent insulate it from the rise in pulp prices and has set up an internal generating capacity that supplies it 94% of its entire power requirements
- If VAT were to be imposed there may be a violent negative short-term market reaction. However, this may provide a buying opportunity

Disclosure appendix

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The following analyst(s), who is(are) primarily responsible for this report, certifies(y) that the views expressed herein accurately reflect their personal view(s) about the subject security(ies) and issuer(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Matt Marsden

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Rating definitions for long-term investment opportunities

Stock ratings

HSBC assigns ratings to its stocks in this sector on the following basis:

For each stock we set a required rate of return calculated from the risk free rate for that stock's domestic, or as appropriate, regional market and the relevant equity risk premium established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the implied return must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands are classified as Neutral.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

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Prior to this, from 7 June 2005 HSBC applied a ratings structure which ranked the stocks according to their notional target price vs current market price and then categorised (approximately) the top 40% as Overweight, the next 40% as Neutral and the last 20% as Underweight. The performance horizon is 2 years. The notional target price was defined as the mid-point of the analysts' valuation for a stock.

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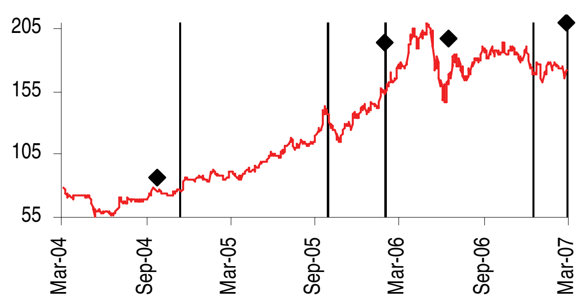
As of 05 March 2007, the distribution of all ratings published is as follows:

Overweight (Buy)	42%	(16% of these provided with Investment Banking Services)
Neutral (Hold)	38%	(15% of these provided with Investment Banking Services)
Underweight (Sell)	20%	(12% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

ITC Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Buy	N/R	15 November 2004
N/R	N/A	29 September 2005
N/A	Overweight	03 February 2006
Overweight	Neutral	19 December 2006
Neutral	Overweight	01 March 2007
Target Price	**Value**	**Date**
Price 1	86.67	28 September 2004
Price 2	N/R	15 November 2004
Price 3	N/A	29 September 2005
Price 4	194.00	03 February 2006
Price 5	197.00	19 June 2006
Price 6	210.00	01 March 2007

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
ITC	ITC.BO	172.50	01-Mar-2007	9

Source: HSBC

1 HSBC* has managed or co-managed a public offering of securities for this company within the past 12 months.
2 HSBC expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.
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9 A covering analyst/s or a member of his/her household has a financial interest in the securities of this company, as detailed below.
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