

**FEBRUARY 22, 2010**
**UPDATE**

Coverage view: **Attractive**

Price (Rs): **249**

Target price (Rs): **300**

BSE-30: **16,192**

**Taxation fears create buying opportunity.** We highlight that the all non-cigarette businesses of ITC will likely contribute positively to incremental profit growth in FY2011E. In the past three years, the cigarette business, in our view, cross-subsidized the other businesses (and hence, higher price increases in cigarettes) to manage company-level profit growth. Taxation worries notwithstanding, we believe there is reasonable headroom for price hikes. The stock trades at 19X FY2011E EPS, BUY.

**Company data and valuation summary**

ITC							
Stock data	Forecasts/Valuations						
	2010	2011E	2012E				
52-week range (Rs) (high,low)	271-156	10.7	13.0	14.7			
Market Cap. (Rs bn)	936.5	23.1	21.5	13.2			
<b>Shareholding pattern (%)</b>							
Promoters	0.0	23.3	19.2	17.0			
FIs	13.1	Sales (Rs bn)	172.1	198.0	228.4		
MFs	3.6	Net profits (Rs bn)	40.2	48.8	55.2		
<b>Price performance (%)</b>	<b>1M</b>	<b>3M</b>	<b>12M</b>	EBITDA (Rs bn)	63.5	74.8	85.8
Absolute	(0.6)	(3.2)	37.3	EV/EBITDA (X)	14.1	11.9	10.2
Rel. to BSE-30	6.4	0.4	(23.3)	ROE (%)	27.2	28.7	28.1
				Div. Yield (%)	1.8	2.2	2.4

We address four fears amongst investors regarding ITC. We find that ITC has reasonable pricing power to manage the worst-case (VAT of 20% *plus* excise increase of 10%). We highlight two likely positive triggers of (1) all non-cigarette businesses contributing to incremental profit growth in FY2011E and (2) potential for reintroduction of Re1 price point.

**Fear #1: All States will increase VAT to 20%**

**Valid.** We believe that the probability of all states increasing VAT on cigarettes to 20% during FY2011E is high. However, contrary to street perception, we believe the impact is likely to be about 3-4% during FY2011E for two reasons, (1) the effective VAT rate for ITC is ~14%, hence the increase, in the worst case, is 6%, (2) typically, VAT rates are increased in state budgets (hence, the effective increase during FY2011E is likely to be ~4%).

**Fear #2: Excise rates will increase in Central budget**

ITC would need to effect a price increase of 5% in the event of a 10% excise increase in the central budget. We expect an increase in applicable excise rates given the reprieve in the Union budget of July 2009. We continue to believe that coinage prices settling at a higher level provide additional pricing power to the cigarette industry (this was demonstrated by the company in the recent price increase in Gold Flake Kings—prices were increased to Rs47/pack of 10 from Rs44, retail prices remain the same at Rs5/stick) and about 30% of the portfolio have not seen price increases for over two years now, including key brands like Wills Navy cut, Scissors etc.

**QUICK NUMBERS**

- All non-cigarette businesses likely contribute to incremental profit growth in FY2011E
- Cumulative price increase of 9% (bear case) would be required in FY2011E, in our view
- Potential for reintroduction of Re1 price point

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**Fear #3: GST—impact of which is yet to be assessed**

Our discussion with industry experts suggests that continuation of the current specified duty structure (under Cenvat) is likely under the GST regime when it is implemented. The White Paper on GST states that tobacco products would be subjected to GST with input tax credit. The Centre may be allowed to levy excise duties on tobacco products over and above GST without input tax credit. The White Paper proposes subsuming nine indirect taxes currently levied by the Centre and six indirect taxes currently levied by the State. The White Paper, however, remains silent on the proposed rates under the new regime. While the street waits for clarity on GST (as we do), we highlight that indirect tax as a proportion of retail price is already at 58% in India—one of the highest amongst developed and developing nations.

**Fear #4: Cigarette business highly sensitivity to price hike**

**Valid.** However, price increases of ~6% per annum are manageable without hurting volumes, in our view. Predictability is preferred by the industry so that price increases can be calibrated over a period of time without hurting consumption and hence volumes. The key challenge which the industry faces is a dip in volumes for a quarter or two when disproportionate price increases are undertaken (volumes typically come back after a quarter or two, given the nature of the product).

Therefore, cumulative price increase of 9% (bear case) would be required in FY2011E, in our view – (1) 4% price increase assuming all States increase VAT to 20% and (2) 5% price increase assuming an excise rate hike of 10%. We highlight that mix improvement likely provides 1-2% pricing benefit as well. Hence, net price increase of about 8%, which is manageable, in our view.

**Positive trigger #1****All non-cigarette businesses contribute to incremental profit growth in FY2011E**

We highlight that all the non-cigarette businesses contribute to incremental profit growth in FY2011E. In the past three years, cigarette business, in our view, cross subsidized the other businesses (and hence higher price increases in cigarettes) to manage the overall profit growth. FMCG losses are expected to be lower in FY2011E, the hotels business is seeing a rebound in demand, paper business will likely derive full benefits of backward integration and focus on value in agri business augurs well for profitability.

**Positive trigger #2****Potential for a reintroduction of Re1 price point exists**

According to ITC, the vacuum created by the exit of the popular low priced micros and plain non-filter cigarettes (in the wake of the heavy imposition of excise duties last year) has been occupied by duty-evaded illegal regular size filter cigarettes which are sold at Re1 per stick. According to ITC, these low priced tax-evaded illegal cigarettes account for about 12-13% of cigarette industry today (~5% in 1HCY08). The industry has asked the government to consider the introduction of a new tax slab that would enable them to offer the consumer tax-paid cigarettes at this price point (we recall that Cenvat to be paid to manufacture any cigarette in India is Rs0.84). This proposal, if accepted and implemented, augurs well for significant uptick in cigarette industry volume growth, in our view.

Stock trades at 19X FY2011E EPS, BUY. Any unexpected increase or change in taxation pose a risk to our BUY rating.

### All non-cigarette businesses contribute to incremental profit growth in FY2011E

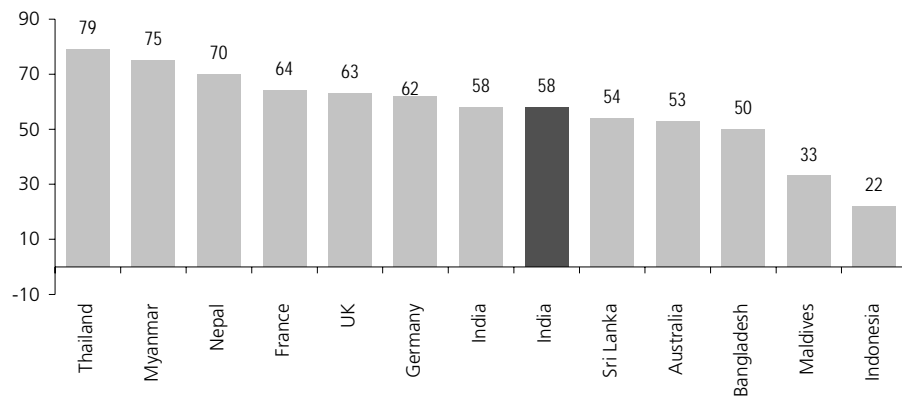
Contribution of various business divisions in absolute incremental profit growth, March fiscal year-ends (%)

	2005	2006	2007	2008	2009	2010E	2011E	2012E
Cigarettes	64	64	74	74	132	132	74	73
Other FMCG	(5)	(5)	(5)	(5)	(53)	(53)	8	4
Hotels	27	27	15	15	(23)	(23)	10	5
Agri Business	2	2	5	5	30	30	2	6
Paperboards, I	13	13	10	10	13	13	6	12

Source: Company, Kotak Institutional Equities estimates

### India already have a penal taxation regime for cigarettes

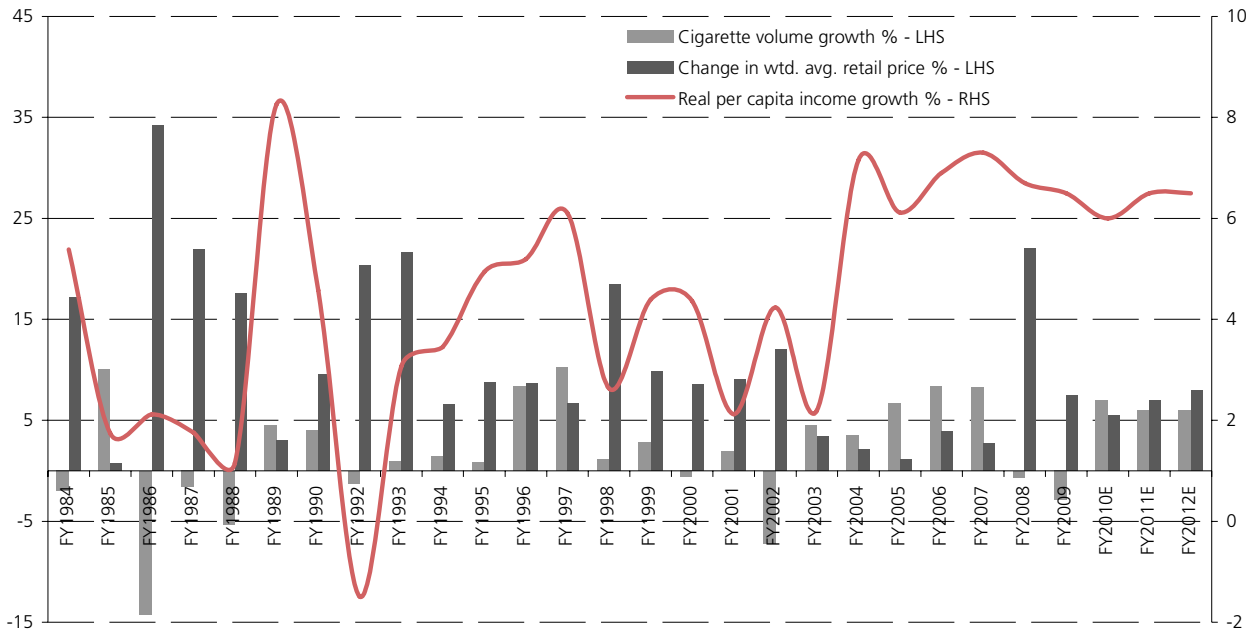
Indirect taxes as a % of cigarette prices across various countries



Source: Kotak Institutional Equities

**Cigarette volumes likely to grow due to sustaining real per capita income growth**

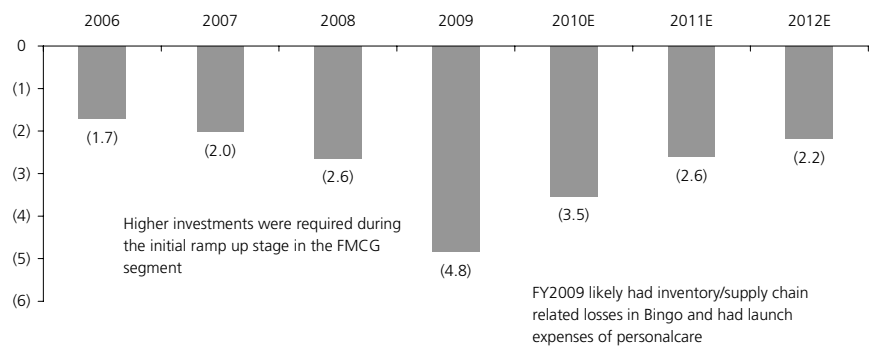
Cigarette volumes growth, average retail price increase and real per capita income growth (%)



Source: Company, Kotak Institutional Equities estimates

**We expect improvement in FMCG losses**

FMCG losses, March fiscal year-ends, 2006-2012E (Rs mn)



Source: Kotak Institutional Equities

ITC: Segment revenue and PBIT, 2006-2011E, March fiscal year-ends (Rs mn)

	2006	2007	2008	2009	2010E	2011E	2012E
<b>Segment revenue, gross (Rs mn)</b>							
Cigarettes	113,297	128,337	138,256	151,151	172,733	194,936	220,435
Other FMCG	10,135	17,044	25,231	30,140	34,382	40,144	46,628
Hotels	7,834	9,857	11,002	10,203	9,151	10,740	13,340
Agri Business	26,784	36,914	38,998	38,460	37,842	43,469	49,747
Paperboards, Paper & Packaging	18,957	21,001	23,643	28,220	32,702	37,529	44,326
TOTAL	177,007	213,152	237,131	258,173	286,811	326,818	374,477
Less: Inter segment revenue	14,763	18,101	23,137	26,738	30,764	36,449	42,333
<b>Gross sales</b>	<b>162,244</b>	<b>195,051</b>	<b>213,994</b>	<b>231,435</b>	<b>256,047</b>	<b>290,369</b>	<b>332,144</b>
Net sales	97,905	123,693	140,012	153,881	172,098	198,025	228,396

<b>Segment revenue break up, (%)</b>							
<b>Cigarettes</b>	<b>69.8</b>	<b>65.8</b>	<b>64.6</b>	<b>65.3</b>	<b>67.5</b>	<b>67.1</b>	<b>66.4</b>
Other FMCG	6.2	8.7	11.8	13.0	13.4	13.8	14.0
Hotels	4.8	5.1	5.1	4.4	3.6	3.7	4.0
Agri Business	16.5	18.9	18.2	16.6	14.8	15.0	15.0
Paperboards, Paper & Packaging	11.7	10.8	11.0	12.2	12.8	12.9	13.3
TOTAL	109.1	109.3	110.8	111.6	112.0	112.6	112.7
Less: Inter segment revenue	9.1	9.3	10.8	11.6	12.0	12.6	12.7
Gross sales	100.0	100.0	100.0	100.0	100.0	100.0	100.0

<b>Segment PBIT margins (Rs mn)</b>							
Cigarettes	27,088	31,722	36,340	41,838	49,733	58,086	66,068
Other FMCG	(1,718)	(2,020)	(2,635)	(4,835)	(3,538)	(2,607)	(2,175)
Hotels	2,581	3,508	4,108	3,162	1,743	2,909	3,422
Agri Business	909	1,236	1,292	2,562	4,530	4,704	5,410
Paperboards, Paper & Packaging	3,514	4,168	4,531	5,086	7,085	7,804	9,117
TOTAL	32,373	38,613	43,636	47,813	59,553	70,896	81,843

<b>Segment PBIT margins (%)</b>							
Cigarettes	23.9	24.7	26.3	27.7	28.8	29.8	30.0
Other FMCG	(17.0)	(11.9)	(10.4)	(16.0)	(10.3)	(6.5)	(4.7)
Hotels	32.9	35.6	37.3	31.0	19.0	27.1	25.7
Agri Business	3.4	3.3	3.3	6.7	12.0	10.8	10.9
Paperboards, Paper & Packaging	18.5	19.8	19.2	18.0	21.7	20.8	20.6
TOTAL	18.3	18.1	18.4	18.5	20.8	21.7	21.9

Source: Company, Kotak Institutional Equities estimates

ITC: Segment revenue, 2006-2011E, March fiscal year-ends (Rs mn)

	2006	2007	2008	2009	2010E	2011E	2012E
<b>Segment revenue, gross (Rs mn)</b>							
Cigarettes	113,297	128,337	138,256	151,151	172,733	194,936	220,435
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Net sales	97,905	123,693	140,012	153,881	172,098	198,025	228,396
<b>Segment revenue growth, (%)</b>							
Cigarettes		13.3	7.7	9.3	14.3	12.9	13.1
Other FMCG		68.2	48.0	19.5	14.1	16.8	16.2
Hotels		25.8	11.6	(7.3)	(10.3)	17.4	24.2
Agri Business		37.8	5.6	(1.4)	(1.6)	14.9	14.4
Paperboards, Paper & Packaging		10.8	12.6	19.4	15.9	14.8	18.1
TOTAL		20.4	11.2	8.9	11.1	13.9	14.6
Gross sales		20.2	9.7	8.2	10.6	13.4	14.4
Net sales		26.3	13.2	9.9	11.8	15.1	15.3

Source: Company, Kotak Institutional Equities estimates

ITC: Profit model, balance sheet, cash flow model 2006-2012E, March fiscal year-ends (Rs mn)

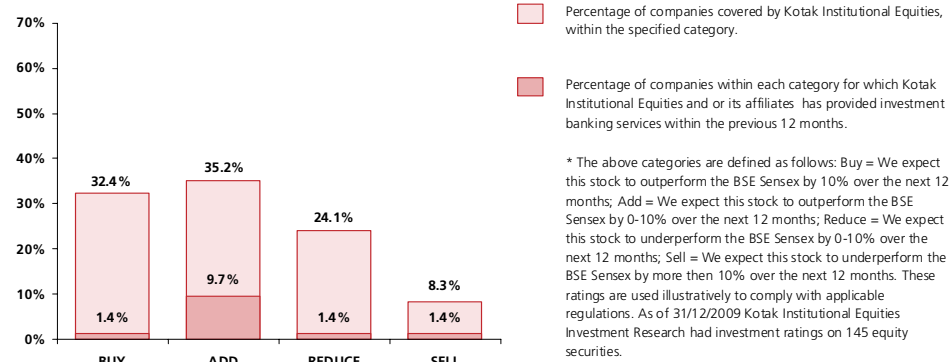
	2006	2007	2008	2009	2010E	2011E	2012E
<b>Profit model (Rs mn)</b>							
Net sales	97,905	123,693	140,012	153,881	172,098	198,025	228,396
<b>EBITDA</b>	<b>33,274</b>	<b>39,700</b>	<b>44,703</b>	<b>48,686</b>	<b>60,192</b>	<b>71,362</b>	<b>82,128</b>
Other income	2,899	3,365	6,109	5,349	6,211	7,819	8,118
Interest	(158)	(169)	(173)	(284)	(511)	(591)	(698)
Depreciation	(3,323)	(3,629)	(4,385)	(5,494)	(6,188)	(7,045)	(8,303)
Extraordinary items	(63)	0	0	0	0	0	0
Pretax profits	32,629	39,267	46,255	48,258	59,705	71,545	81,245
Tax	(10,276)	(12,267)	(14,517)	(15,622)	(19,533)	(22,730)	(26,007)
<b>Net profits</b>	<b>22,353</b>	<b>27,000</b>	<b>31,738</b>	<b>32,636</b>	<b>40,172</b>	<b>48,815</b>	<b>55,238</b>
<b>Earnings per share (Rs)</b>	<b>6.0</b>	<b>7.2</b>	<b>8.4</b>	<b>8.7</b>	<b>10.7</b>	<b>13.0</b>	<b>14.7</b>
<b>Balance sheet (Rs mn)</b>							
Total equity	90,615	104,371	120,577	137,351	157,698	182,284	211,089
Deferred taxation liability	3,248	4,729	5,451	8,672	8,672	8,672	8,672
Total borrowings	1,197	2,009	2,144	1,776	1,776	1,776	1,776
Current liabilities	35,781	38,576	44,323	47,050	47,816	50,830	54,698
<b>Total liabilities and equity</b>	<b>130,840</b>	<b>149,684</b>	<b>172,495</b>	<b>194,848</b>	<b>215,962</b>	<b>243,561</b>	<b>276,234</b>
Cash	8,558	9,002	5,703	10,324	28,666	34,624	45,981
Current assets	43,061	53,896	64,490	71,287	71,651	78,564	85,354
Total fixed assets	44,051	56,109	72,956	84,860	87,267	101,995	116,522
Investments	35,170	30,678	29,346	28,378	28,378	28,378	28,378
<b>Total assets</b>	<b>130,840</b>	<b>149,684</b>	<b>172,495</b>	<b>194,848</b>	<b>215,962</b>	<b>243,561</b>	<b>276,234</b>
<b>Free cash flow (Rs mn)</b>							
Operating cash flow, excl. working capital	25,638	31,040	37,112	41,493	46,963	56,355	64,048
Working capital	(5,469)	(8,667)	(6,634)	(4,977)	1,722	(2,784)	(1,058)
Capital expenditure	(6,013)	(15,702)	(21,239)	(17,407)	(8,605)	(21,783)	(22,840)
Investments	3,577	4,492	1,332	968	0	0	0
<b>Free cash flow</b>	<b>17,734</b>	<b>11,164</b>	<b>10,570</b>	<b>20,077</b>	<b>40,081</b>	<b>31,788</b>	<b>40,151</b>
<b>Key ratios (%)</b>							
Sales growth	28.2	26.3	13.2	9.9	11.8	15.1	15.3
EBITDA margin	34.0	32.1	31.9	31.6	35.0	36.0	36.0
EPS growth	28.3	20.1	17.1	2.8	23.1	21.5	13.2

Source: Company, Kotak Institutional Equities estimates

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#### Kotak Institutional Equities Research coverage universe

Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of December 31, 2009

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**ADD.** We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

**REDUCE.** We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

**SELL.** We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

Our target price are also on 12-month horizon basis.

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