MOTILAL OSWAL

ITC

STOCK INFO.	BLOOMBERG
BSE Sensex: 14,091	ITC IN
	REUTERS CODE
S&P CNX: 4,083	ITC.BO

Equity Shares (m)	3,755.2
52-Week Range	213/140
1,6,12 Rel. Perf. (%)	-3/-27/-30
M.Cap. (Rs b)	652.3
M.Cap. (US$ b)	14.8

31 January 2007 — **Buy**

Previous Recommendation: Buy — Rs174

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
03/06A	97,905	22,803	6.1	24.1	28.6	7.2	25.2	34.6	6.2	18.3
03/07E	122,710	27,831	7.4	22.1	23.4	6.3	26.7	37.5	4.9	14.9
03/08E	145,213	32,977	8.8	18.5	19.8	5.4	27.3	38.0	4.1	12.6

- ITC's 3QFY07 results were better than expected. EBITDA margins declined 20bp to 34.2% against our estimate of a 250bp decline to 31.9%. Higher margins in cigarettes and hotels, coupled with lower losses in other FMCG business, enabled a much lower than expected decline in overall margins. Adjusted PAT grew 23.2% to Rs7.2b, higher than our estimate of Rs7b. Revenue growth at 24% to Rs31.7b was in line with our estimate.
- Cigarette revenues grew 13.8% to Rs32.8b, driven by 7.5-8% volume growth and better sales mix. Other FMCG business grew 67.6% to Rs4.3b. Hotels grew 28.5% to Rs2.9b, with 55% growth in PBIT following a 37% increase in revenue per room. Agri and paper business grew 19.5% and 11%, respectively.
- The company continues to grow its cigarette volumes at 7.5-8% and is also witnessing improved profitability in other businesses. We remain positive on the long-term prospects of the company. In the near term, VAT implementation remains an overhang. If the rate is high (8-12.5%), it could adversely impact cigarette volumes in the near term. However, if the rate is 4-5%, we do not see any major impact.
- We estimate EPS at Rs7.4 for FY07 and Rs8.8 for FY08. The stock is currently trading at 23.4x FY07E and 19.8x FY08E EPS. We maintain **Buy**.

QUARTERLY PERFORMANCE (Rs Million)

Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Net Sales	**22,669**	**21,832**	**25,560**	**27,845**	**28,498**	**28,876**	**31,656**	**33,680**	**97,905**	**122,710**
YoY Change (%)	*24.7*	*22.2*	*37.5*	*27.9*	*25.7*	*32.3*	*23.8*	*21.0*	*28.2*	*25.3*
Total Exp	14,401	13,633	16,777	19,768	18,792	19,149	20,828	23,221	64,579	81,990
EBITDA	**8,268**	**8,198**	**8,783**	**8,077**	**9,706**	**9,727**	**10,828**	**10,459**	**33,326**	**40,720**
Margins (%)	*36.5*	*37.6*	*34.4*	*29.0*	*34.1*	*33.7*	*34.2*	*31.1*	*34.0*	*33.2*
Depreciation	-801	-830	-831	-862	-876	-910	-921	-895	-3,323	-3,602
Interest	-11	3	-15	-188	-7	-35	9	8	-211	-25
Other Income	845	781	489	785	849	795	698	900	2,899	3,242
PBT	**8,301**	**8,152**	**8,426**	**7,811**	**9,672**	**9,578**	**10,614**	**10,473**	**32,691**	**40,335**
Tax	-2,718	-2,429	-2,603	-2,138	-3,149	-2,782	-3,440	-3,134	-9,888	-12,504
Rate (%)	*32.7*	*29.8*	*30.9*	*27.4*	*32.6*	*29.0*	*32.4*	*29.9*	*30.2*	*31.0*
Reported PAT	**5,583**	**5,723**	**5,823**	**5,674**	**6,523**	**6,796**	**7,174**	**7,339**	**22,803**	**27,831**
YoY Change (%)	*20.1*	*17.3*	*24.8*	*35.9*	*16.8*	18.7	23.2	*26.0*	*24.1*	*22.1*
Extraordinary Inc/(Exp)	195	0	454	4	0	0	0	0	450	0
Adjusted PAT	**5,388**	**5,723**	**5,368**	**5,670**	**6,523**	**6,796**	**7,174**	**7,339**	**22,353**	**27,831**
YoY Change (%)	*15.9*	*17.3*	*15.0*	*-26.5*	*21.1*	18.7	*33.6*	*36.7*	*2.0*	*24.5*

E: MOSt Estimates

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SEGMENT-WISE PERFORMANCE (YOY %)

ITC - SEGMENTAL	1QFY06	2QFY06	3QFY06	4QFY06	1QFY07	2QFY07	3QFY07
Sales Growth (%, YoY)							
Cigarettes	12.0	7.2	19.1	15.1	11.1	13.9	13.8
FMCG - Others	90.4	87.1	71.2	75.7	79.6	65.9	67.6
Hotels	35.5	27.1	31.4	45.5	35.3	30.5	28.5
Agri Business	64.2	15.5	63.1	55.8	47.4	86.6	19.5
Paper and Packaging	22.1	21.9	25.3	15.5	8.8	11.1	11.0
EBIT Margin (%)							
Cigarettes	24.4	25.1	24.1	22.1	25.8	25.4	25.3
FMCG - Others	-27.3	-14.3	-15.1	-13.9	-16.2	-12.0	-10.6
Hotels	20.0	17.9	35.0	37.1	29.0	28.8	42.0
Agri Business	4.8	6.6	2.3	1.1	4.2	5.3	2.8
Paper and Packaging	19.4	19.5	18.7	16.5	20.9	21.2	19.2

Source: Company/Motilal Oswal Securities

ITC's 3QFY07 results were better than expected

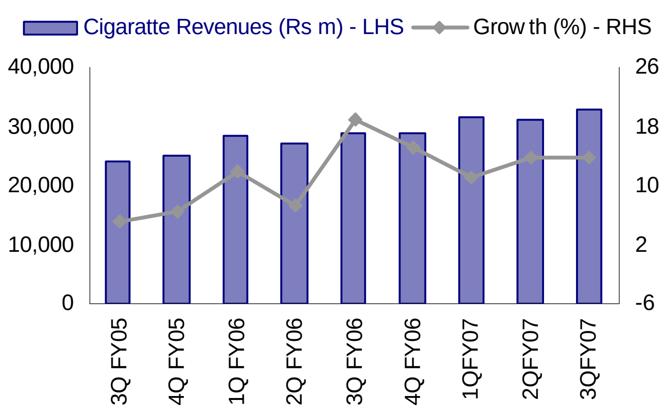
Revenue growth at 24% to Rs31.7b was in line with our estimate. EBITDA margins declined 20bp to 34.2% against our estimate of a 250bp decline to 31.9%. Higher margins in cigarettes and hotels, coupled with lower losses in other FMCG business, enabled a much lower than expected decline in overall margins. Adjusted PAT grew 23.2% to Rs7.2b, higher than our estimate of Rs7b.

Cigarette business growth accelerates

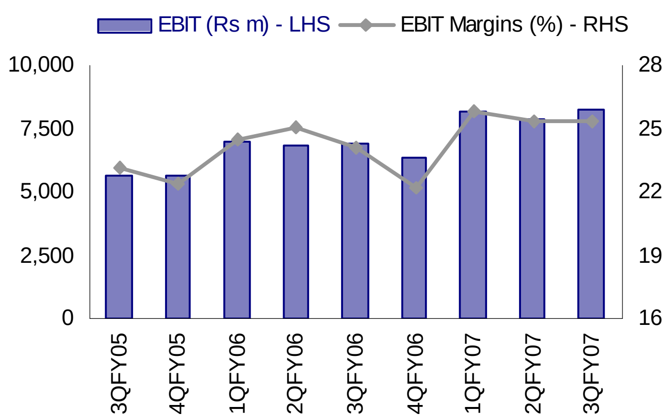
Cigarette revenues grew 13.8% YoY to Rs32.8b, driven by 7.5-8% volume growth, price increases and mix changes. ITC raised the prices of *Gold Flake Filter* by 5%, *Scissors Plane* by 13% and *Classic King Size* by 5%. PBIT margins for the quarter expanded by 120bp to 25.3%.

Cigarette volumes are growing due to rising affordability and relatively lower price increases in the past few years. We believe that the cigarette business offers scope for sustained volume growth, as cigarettes constitute just 14% of the total tobacco consumed in India. Users that consume tobacco in multiple formats are rising (currently 61%) – this should continue to fuel demand for cigarettes.

CIGARETTES - STRONG GROWTH MOMENTUM CONTINUES



CIGARETTES – STEADY MARGIN EXPANSION



Source: Company

However, impending implementation of VAT could be a short-term dampener for ITC. The company beleives that double-digit VAT on MRP could adversely impact revenue collection, which has been rising steadily by 12-13%. The next few quarters will determine the trend in the imposition of VAT as against the current sales tax rate of nil. If the rate is high (8-12%), it could have a dampening impact on near-term volume growth. However, if the VAT rate is 4-5%, we do not see a major impact on demand. We have not factored in any impact of VAT in our numbers. Based on strong volume growth during the nine months, we expect 8% volume growth for FY07 and 7% volume growth for FY08.

Processed foods continue to power other FMCG business growth

Other FMCG business grew 67.6% YoY during 3QFY07. Besides food products and lifestyle retailing, other businesses like *Classmate* notebooks, *Mangaldeep* incense sticks, *Aim* matchboxes and *Impressions* greeting cards continue to gain ground and maintain category leadership.

Food products continued to power growth, with 65% YoY growth during 3QFY07. *Aashirvaad* atta (wheat flour) consolidated its leadership position, with market share touching 55%.

- Product mix in biscuits improved, with enhanced sales of cookies, cream-biscuits, etc. and the introduction of *Sunfeast Special* in the fast growing mid-price cookies segment.
- ITC is establishing its own production facilities at Bangalore and Uttaranchal, apart from tying up additional outsourced manufacturing capacity, with a view to reducing the costs and servicing proximal markets efficiently.
- Product range of pasta was further expanded, with the launch of *Sunfeast Benne Vita* in four variants.
- The company expanded its presence in the 'confectionery' segment, with the success of *éclairs*, *Cofitino*, and national rollout of *Mango Natkhat* and launch of *Maha Mango*.

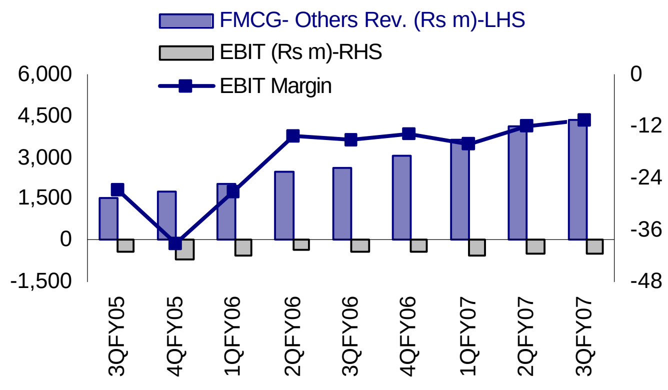
We expect the branded foods business to continue its growth momentum backed by differentiated products and innovation according to the tastes of the Indian consumer. We believe that ITC seems best placed to exploit the expected surge in demand for branded foods due to cuisine experience of the Welcome Group, strong R&D and strong back-end provided by its e-Choupal network. The biscuits business has seen sharp increase in costs due to rise in wheat costs, but the company has hinted at continuation of aggressive strategy in the advertising and launch of new products in this fast growth and largest processed food category.

Lifestyle retailing: Sales during the quarter grew by over 38% YoY. All the major lifestyle brands like *Classic*, *Wills Sport* and *Wills Clublife* maintained growth momentum, driven by consumer franchisee expansions. The company plans to enhance its retail footprint, with the launch of 15 new stores in upcoming malls progressively over the next few months. The brand's association with high fashion and imagery stood reinforced with the resounding success of the second *Wills Lifestyle India Fashion Week* (WIFW) held in August-September 2006. The future holds good potential as:

- Branded garments are likely to grow by more than 20% per annum due to rising impact of media and organized retailing
- There is a perceptible shift in trend away from tailoring even in category two towns, which augurs well for mass market brands like *John Players*
- Improving distribution network will increase the availability and boost sales
- ITC has been able to find the right product and brand mix, with extension into outwear, denims, premium and popular segments

The company has established long-term partnerships with high potential customers for exports. It has also entered into an exclusive manufacturing arrangement with a state-of-the-art unit located at the Noida SEZ.

OTHER FMCG BUSINESS PERFORMANCE



Source: Company

Businesses like stationery, greeting cards and matchboxes continued to gain ground, with stationery business growing by 27% YoY.

E-Choupal and Choupal Sagar – huge investments in pipeline

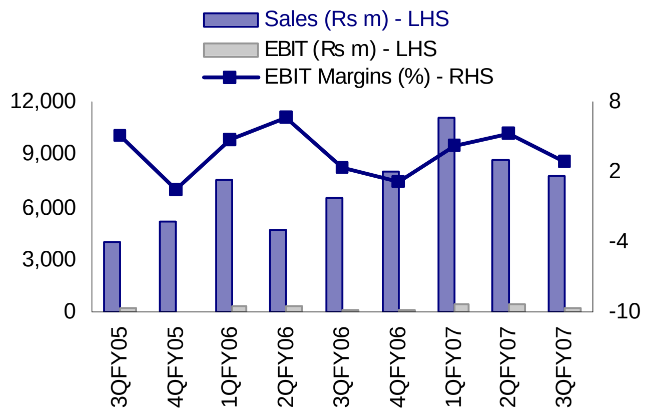
Agri business reported 19.5% topline growth for 3QFY07 while PBIT increased by 45.2%. PBIT margin expanded 150bp to 2.8%. Growth was lead by exports of leaf tobacco and increased levels of trade in soya, non-basmati rice, chana (chick pea) and coffee.

The e-Choupal network was further ramped up during the quarter to 6,500 installations from 6,270 in June 2006. The network now reaches out to over 3.5m farmers in the states of Madhya Pradesh, Haryana, Uttaranchal, Uttar Pradesh, Rajasthan, Karnataka, Maharashtra, Andhra Pradesh and Kerala.

Rural retail initiative gained momentum, with the launch of 1 more 'Choupal Sagar' during the quarter. ITC now has 12 'Choupal Sagars' operational in the three states of Madhya Pradesh, Maharashtra and Uttar Pradesh while 8 more are likely to start operations by April 2007. ITC plans to increase the number of 'Choupal Sagars' to 40 in the coming 12 months. Existing 'Choupal Sagars' continue to ramp up well with rising customer affiliation and strong support from companies, which have identified e-Choupal as a tool to enter the rural hinterlands. The company expects the 'Choupal Sagars' to break even in two years from the date of commissioning of stores. Management seems unperturbed by the planned entry of Reliance Retail in rural India. ITC is also progressing a pilot project for retailing fruits and vegetables. Three cash-and-carry stores are currently operational at Hyderabad, Pune and Chandigarh.

Despite lower profit margins on a standalone basis, this initiative holds excellent long-term value in synergistic combination with branded foods and ITC's rural distribution strategy.

AGRI BUSINESS PERFORMANCE



Source: Company

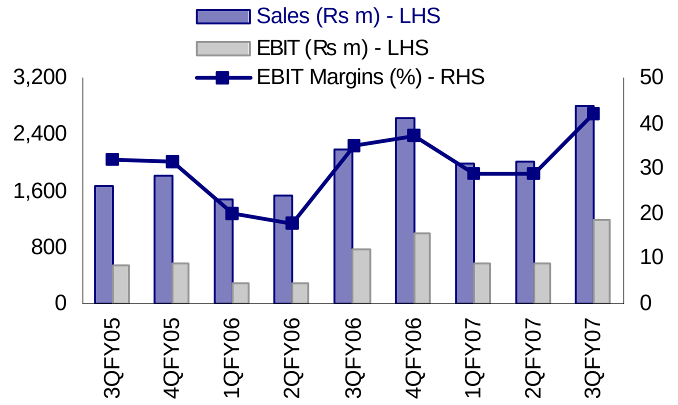
Hotels – boom times continue

Hotels reported 28.5% increase in topline and 55% increase in PBIT. PBIT margins expanded by 700bp. Improvement in performance was on the back of 37% increase in revenue per room, driven mainly by WelcomHotel, NewDelhi, Grand Maratha Sheraton & Towers, ITC Hotel Windsor Sheraton & Towers and ITC Maurya Sheraton &Towers.

Construction activity of a new super-deluxe luxury hotel at Bangalore is progressing as per plans while the groundwork for the project at Chennai is expected to commence in another 4-5 months. We expect the hotel division to grow in the coming year on the back of higher occupancy levels and higher average revenue per room. Margins are expected to expand further as the current buoyancy in room rentals is expected to last for the coming couple of years due to long gestation nature of the industry.

ITC expects Bangalore to witness some decline in average room rent in 2008-09 but volume growth from new property is expected to more than make up for the same. The company foresees delays in the properties being commissioned due to which the current phase of buoyancy is expected to continue beyond FY08.

HOTELS BUSINESS PERFORMANCE



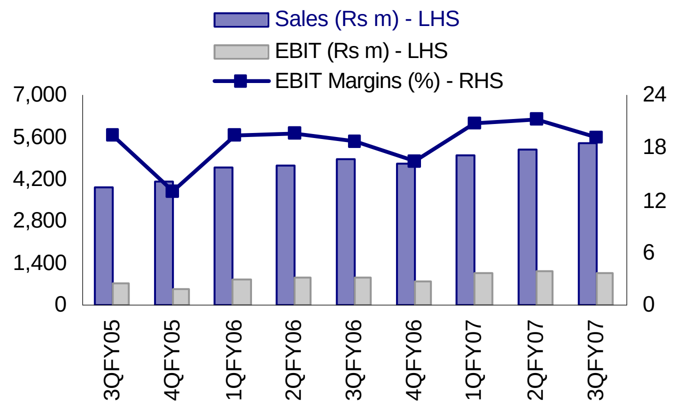
Source: Company

Paperboards and Paper – higher capacity utilization pays off

ITC's paperboard division reported 11% sales growth and 14% PBIT growth. PBIT margins expanded 50bp to 19.2%. Increased capacity utilization at Kovai, benefits of captive power plant and 75,000 ton capacity increase at Bhadrachalam, powered growth. Sales of value-added products touched 55% of total paper sales during the quarter. Raw material costs continued trending up during 1HFY07, due to which the company has undertaken 5.5% price increase so far.

The company is in the process of augmenting the paperboard capacity by 90,000 ton per year by FY09, which would be an integrated facility including captive power. In addition, the company is planning to invest in a 100,000 ton uncoated paper capacity, including branded copier grades. This capacity is also expected to come on stream by FY09. The company is expanding the capacity of cartons, flexibles and cigarette packaging unit to cater to growing demand of new FMCG and cigarettes divisions. We expect the paperboard SBU to report steady growth in sales and profits. Growth rates are expected to accelerate further once the company-conceived Rs25b project materializes. It has not been able to finalize any location so far.

PAPER BUSINESS PERFORMANCE



Source: Company

Valuation and view

We expect ITC to maintain strong growth in the coming quarters due to strong business momentum in cigarettes and hotels. We expect the paper business to continue its good show due to benefits from stablisation of new line and rising sales of value added paperboards. Biscuits, atta and lifestyle retailing would drive the growth in new FMCG business, with turnaround likely by FY09. Our EPS estimates stands at Rs7.4 for FY07 and Rs8.8 for FY08. The stock is currently trading at 23.4x FY07E and 19.8x FY08E EPS. We maintain **Buy**.

ITC: an investment profile

Company description

ITC is an associate of BAT (British American Tobacco) controls more than 2/3rd of the cigarette market in India. ITC has emerged as a diversified conglomerate with leading presence in Paperboards, Hotels and Processed foods. E-Choupal, the agri rural initiative of the company has been widely appreciated for its foresight in harnessing the potential in the rural market.

Key investment arguments

- Strong pricing power due to dominant market share in the cigarettes
- Hotels and Paperboard businesses have achieved self sustenance levels
- Fastest growing company in the processed food sector
- Excellent long term potential in its rural initiative of E Choupal and Choupal Sagar

Key investment risks

- A high indirect tax regime could dampen cigarette growth.
- Some of the SBU's like paper and Hotels are capital intensive with long gestation periods.

Recent developments

- Setting up manufacturing capacity for 100,000 ton per year of uncoated paper, including branded copier grades
- Setting up a super-deluxe hotel in Bangalore; planning to develop another at Chennai
- Branded packaged foods business expanded, with rollout of variants like 'Mango Natkhat', 'Maha Mango', and 'Sunfeast Benne Vita' pasta.

Valuation and view

- We estimate EPS at Rs7.4 for FY07E and Rs8.8 for FY08E, a CAGR of 20% over FY06-08.
- The stock is currently trading at 23.4x FY07E and 19.8x FY08E EPS. We maintain **Buy.**

Sector view

- We are positive on the FMCG sector and is showing strong volume growth across product categories with improving pricing power for leading players.
- Companies with low competitive pressures and broad product portfolios will be able to better withstand any slowdown in a particular segment.
- Longer term prospects bright, given rising incomes and low penetration.

COMPARATIVE VALUATIONS

		ITC	HLL	NESTLE
P/E (x)	FY07E	23.4	30.6	34.2
	FY08E	19.8	24.8	27.7
EV/EBITDA (x)	FY07E	14.9	26.0	21.0
	FY08E	12.6	20.9	17.7
EV/Sales (x)	FY07E	4.9	3.6	4.2
	FY08E	4.1	3.2	3.8
P/BV (x)	FY07E	6.3	17.7	18.5
	FY08E	5.4	15.4	16.2

SHAREHOLDING PATTERN (%)

	DEC.06	SEP.06	DEC.05
Promoter	0.0	0.0	0.0
Domestic Inst	37.3	36.8	35.6
Foreign	47.3	47.7	49.1
Others	15.4	15.5	15.3

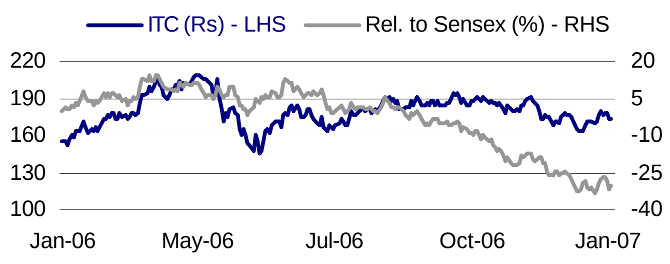
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	7.4	7.3	1.2
FY08	8.8	8.7	0.6

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
174	195	12.3	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT (RS MILLION)

Y/E MARCH	2005	2006E	2007E	2008E	2009E
Net Sales	**76,395**	**97,905**	**122,710**	**145,213**	**169,409**
Change (%)	*18.5*	*28.2*	*25.3*	*18.3*	*16.7*
Total Expenditure	-48,438	-64,579	-81,990	-97,851	-116,376
EBITDA	**27,956**	**33,326**	**40,720**	**47,362**	**53,033**
Change (%)	*18.2*	*19.2*	*22.2*	*16.3*	*12.0*
Margin (%)	*36.6*	*34.0*	*33.2*	*32.6*	*31.3*
Depreciation	-3,129	-3,323	-3,602	-3,966	-5,370
Int. and Fin. Charges	-508	-211	-25	-25	-20
Other Income - Recurring	2,411	2,899	3,242	3,738	4,310
Profit before Taxes	**26,731**	**32,691**	**40,335**	**47,109**	**51,953**
Change (%)	*15.3*	*22.3*	*23.4*	*16.8*	*10.3*
Margin (%)	*35.0*	*33.4*	*32.9*	*32.4*	*30.7*
Tax	-7,879	-10,584	-13,351	-14,839	-16,365
Deferred Tax	-481	696	847	989	1,091
Tax Rate (%)	*-31.3*	*-30.2*	*-31.0*	*-29.4*	*-29.4*
Profit after Taxes	**18,371**	**22,803**	**27,831**	**32,977**	**36,367**
Change (%)	*15.4*	*24.1*	*22.1*	*18.5*	*10.3*
Margin (%)	*24.0*	*23.3*	*22.7*	*22.7*	*21.5*
Non-rec. (Exp)/Income	3,543	-450	0	0	0
Reported PAT	**18,371**	**22,353**	**27,831**	**32,977**	**36,367**

BALANCE SHEET (RS MILLION)

Y/E MARCH	2005	2006E	2007E	2008E	2009E
Share Capital	2,482	3,755	3,755	3,755	3,755
Reserves	76,474	86,860	100,601	116,884	134,840
Net Worth	**78,956**	**90,615**	**104,357**	**120,639**	**138,595**
Loans	2,454	1,197	0	0	0
Deferred Liability	3,761	3,248	3,376	3,509	3,644
Capital Employed	**85,171**	**95,060**	**107,732**	**124,147**	**142,239**
Gross Block	57,463	62,272	69,272	76,272	103,272
Less: Accum. Depn.	-17,955	-20,654	-24,257	-28,223	-33,593
Net Fixed Assets	**39,508**	**41,617**	**45,015**	**48,049**	**69,679**
Capital WIP	1,862	2,434	8,000	14,000	4,000
Investments	38,747	35,170	45,365	52,372	57,610
Curr. Assets, L&A	**35,393**	**51,619**	**53,472**	**60,268**	**67,332**
Inventory	20,030	26,363	34,150	39,521	45,597
Account Receivables	5,278	5,480	6,051	6,962	7,658
Cash and Bank Balance	557	8,558	1,544	1,532	1,264
Others	9,529	11,218	11,726	12,252	12,813
Curr. Liab. and Prov.	**30,338**	**35,781**	**44,121**	**50,542**	**56,381**
Account Payables	18,920	21,484	26,620	30,069	33,852
Other Liabilities	2,171	2,675	2,919	3,300	3,591
Provisions	9,247	11,622	14,582	17,172	18,938
Net Current Assets	**5,055**	**15,838**	**9,351**	**9,726**	**10,951**
Application of Funds	**85,171**	**95,060**	**107,732**	**124,147**	**142,240**

E: MOSt Estimates

RATIOS

Y/E MARCH	2005	2006E	2007E	2008E	2009E
Basic (Rs)					
EPS	**4.9**	**6.1**	**7.4**	**8.8**	**9.7**
Cash EPS	5.7	7.0	8.4	9.8	11.1
BV/Share	21.0	24.1	27.8	32.1	36.9
DPS	2.0	2.6	3.3	4.0	4.4
Payout %	41.9	43.6	45.0	45.0	45.0
Valuation (x)					
P/E		28.6	23.4	19.8	17.9
Cash P/E		25.0	20.8	17.7	15.6
EV/Sales		6.2	4.9	4.1	3.5
EV/EBITDA		18.3	14.9	12.6	11.2
P/BV		7.2	6.3	5.4	4.7
Dividend Yield (%)		1.5	1.9	2.3	2.5
Return Ratios (%)					
RoE	23.3	25.2	26.7	27.3	26.2
RoCE	32.0	34.6	37.5	38.0	36.5
Working Capital Ratios					
Debtor (Days)	25	20	18	18	17
Asset Turnover (x)	0.9	1.0	1.1	1.2	1.2
Leverage Ratio					
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT (RS MILLION)

Y/E MARCH	2005	2006E	2007E	2008E	2009E
OP/(loss) before Tax	24,827	30,003	37,118	43,396	47,663
Int./Div. Received	2,411	2,899	3,242	3,738	4,310
Depreciation and Amort.	3,129	3,323	3,602	3,966	5,370
Interest Paid	-508	-211	-25	-25	-20
Direct Taxes Paid	-7,879	-10,584	-13,351	-14,839	-16,365
(Incr)/Decr in WC	-5,311	-2,782	-527	-387	-1,494
CF from Operations	**16,670**	**22,648**	**30,060**	**35,849**	**39,464**
(Incr)/Decr in FA	-8,777	-5,382	-12,566	-13,000	-17,000
(Pur)/Sale of Investments	-8,207	3,577	-10,194	-7,007	-5,238
CF from Invest.	**-16,985**	**-1,804**	**-22,759**	**-20,006**	**-22,236**
Issue of Shares	872	1,923	0	0	0
(Incr)/Decr in Debt	-150	-149	-149	-149	-148
Dividend Paid	-8,792	-11,347	-14,090	-16,694	-18,411
Others	8,602	-3,270	-76	988	1,062
CF from Fin. Activity	**532**	**-12,843**	**-14,315**	**-15,855**	**-17,497**
Incr/Decr of Cash	**217**	**8,002**	**-7,014**	**-12**	**-268**
Add: Opening Balance	340	557	8,558	1,544	1,532
Closing Balance	**557**	**8,558**	**1,544**	**1,533**	**1,264**

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Disclosure of Interest Statement	ITC
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No