

March 4, 2008

Rating	Outperformer
Price	Rs193
Target Price	Rs214
Implied Upside	10.9%
Sensex	16,678

(Prices as on March 3, 2008)

Trading Data

Market Cap. (Rs bn)	726.1
Shares o/s (m)	3,762.2
Free Float	56.0%
Avg. Daily Vol ('000)	1,517.2
Avg. Daily Value (Rs m)	314.1

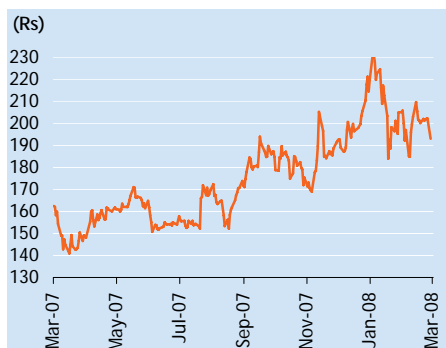
Major Shareholders

Promoters	NA
Foreign	47.4%
Domestic Inst.	39.9%
Public & Others	12.7%

Stock Performance

(%)	1M	6M	12M
Absolute	(6.0)	12.3	15.7
Relative	4.8	4.6	(13.5)

Price Performance (RIC: ITC.BO, BB: ITC IN)



Source: Bloomberg

ITC

Post-budget analysis

As per the proposal in the Union Budget 2008-09, excise hike on non-filter cigarettes (142% on plains and 388% on micros) have resulted in structural changes in the excise levied, as plains which are low priced cigarettes would generate higher excise per cigarette than RSFT.

- We expect ITC to take price hike of 15.8% with volume loss of 2.7%.
 - ITC will like to maintain brand and price point laddering.
 - It will not hike KSFT and MKFT price as there exists the price ladder, and also its competitors like *Marlboro* may not hike prices.
 - RSFT prices will be hiked to maintain price ladder from Rs2-3, and also to maintain premium of RSFT above plains.
- The larger the player the lesser the dependence on non-filters. We believe the impact of excise hikes would be higher on small players and would further marginalise them.
 - Impact of excise hikes would be higher on small players like GTC and VST, as their contribution of non-filters to total volume is high at 97% and 59% respectively.
 - GPI, with 65% contribution from filters, may be able to mitigate its volume loss to competition and may be able to bridge its cigarette volume loss through its planned entry into other forms of tobacco.
- We revise our earning estimate for FY08E from Rs8.40 to Rs8.35, for FY09E from Rs10.14 to Rs9.84 and for FY10E from Rs11.50 to Rs11.48. At the CMP of Rs193, the stock trades at 19.6x FY09E. We maintain Outperformer rating on the stock with a revised target price of Rs214.

Key financials (Y/e March)	FY07	FY08E	FY09E	FY10E
Revenue (Rs m)	123,693	138,879	161,108	191,144
Growth (%)	26.3	12.3	16.0	18.6
EBITDA (Rs m)	39,564	43,711	51,955	61,291
PAT (Rs m)	27,000	31,413	37,008	43,209
EPS (Rs)	7.2	8.3	9.8	11.5
Growth (%)	18.4	16.3	17.8	16.8
Net DPS (Rs)	3.2	3.8	4.4	5.2

Source: Company Data; PL Research

Profitability & valuation	FY07	FY08E	FY09E	FY10E
EBITDA margin (%)	32.0	31.5	32.2	32.1
RoE (%)	27.7	27.8	28.1	28.1
RoCE (%)	26.2	26.4	27.1	27.5
EV / sales (x)	5.8	5.1	4.3	3.5
EV / EBITDA (x)	18.2	16.1	13.3	10.9
PE (x)	26.9	23.1	19.6	16.8
P / BV (x)	7.0	6.0	5.1	4.4
Net dividend yield (%)	1.7	2.0	2.3	2.7

Source: Company Data; PL Research

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Excise Restructuring

As per the proposal in the Union Budget 2008-09, excise hike on non-filter cigarettes (142% on plains and 388% on micros) have resulted in structural changes in the excise levied, as plains which are low priced cigarettes would generate higher excise per cigarette than RSFT. This results in further widening of gap between cigarettes and other forms of tobacco, viz. bidis and chewing tobacco.

Tax scenario (FY07-08)

	Specific excise duty per 1,000 sticks	FY07-08	FY08-09
Filters	Kings	1,811	1,811
	Mini Kings	1,362	1,362
	RSFT	844	844
Non-filters	Plains	562	1,362
	Micros	173	844
* including 3% education cess			
VAT		12.5%	12.5%

Source: PL Research

Good for filterisation trend, but curse for non-filter smokers

This change spells well for the industry as far as filterisation trend goes; however, for the large set of plains and micros smokers, it would be a huge hike. Smokers of plains and micros are those who wish to smoke cigarettes but can not afford filter cigarettes, and as such the chances of consumption loss is quite higher.

Impact on Industry

Contribution of non-filters to total volume has been declining since the last 15 years. Non-filters contributed 29% of the industry volume in 10 months of FY07-08, down from 31% in the same period of FY06-07. However, the present excise hike carries the risk of moving about 12 million smokers away from the cigarette industry. Therefore, we believe that the companies in the industry will take the price hike rationally so as to pass on the additional excise burden, but at the same time minimise loss of smokers from the industry.

Contribution of non-filters for each company

	Industry	ITC	GPI	VST	GTC
Non-filters (% of volume)	29%	19%	35%	59%	97%
Market Share (%)		73%	12%	8%	6%

Source: PL Research

We see that larger the player, the lower the dependence on non-filters. Hence, we believe that the impact of this excise restructuring would be highest on smaller players and would further marginalise them. Moreover, the impact of the decline in non-filters would be felt more by companies in terms of sales and distribution restructuring as serving some territories might become unviable for them. However, it could be a loss for the entire industry if smokers of non-filter cigarettes shift to other forms of tobacco. Just for comparison purpose, a bidi costs about Re0.20, while the cheapest cigarette would now cost about Re1, an increasing price gap from 2.5x to 5x.

Impact on GTC, VST and GPI

In our opinion, price hikes would be highly negative for GTC and VST as they carry higher risk of losing volume. GPI, with 65% contribution from filters, may be able to mitigate its volume loss to competition and may be able to bridge its cigarette volume loss through its planned entry into other forms of tobacco.

Impact on ITC

In response to the recent excise hike in the budget, we have worked out a scenario which ITC is most likely to adopt.

Our assumption is that ITC would not change its brand and price point laddering and would offer choice to every consumer to upgrade/downgrade at various price points. KSFT and MKFT prices would not be touched, while RSFT prices would be changed to maintain the ladder.

Likely price volume scenario for (FY08-09)

	% of ITC's volume portfolio (FY07-08)*	Price hike	Volume
KSFT	8.9%	0%	10.8%
MKFT	6.3%	0%	2.0%
RSFT	65.6%	12.4%	4.4%
Plains	13.5%	32.0%	-27.8%
Micros	5.6%	140.9%	-51.6%
Total		15.8%	-2.7%
EPS		9.84	
Merits		Price hike in RSFT, plains and micros to retain brand and price point laddering	
Demerits		Risk of losing higher volume in RSFT if competition does not take according price hike	

Source: PL Research

* 10 months FY08

Keeping in mind ITC's brand and price point laddering, we believe this scenario is highly probable as it helps retain the ladder above Rs3, and in shifting the entire ladder from Rs0.50 to Rs2.50, a notch above.

ITC brand and price point laddering

Existing		Likely scenario	
Micros	Re 0.50		
No offering	Rs 1	No offering	Rs 0.5 - Rs 1.00
Plains	Rs 1.25 - 1.75	Micros	Rs 1.25 - Rs 1.50
RSFT	Rs 1.75 - Rs 2.50	Plains	Rs 1.75 - Rs 2.25
No offering	Rs 3.00	RSFT	Rs 2.00 - Rs 3.00
MKFT	Rs 3.50	MKFT	Rs 3.50
KSFT	Rs 4.00 - Rs 5.00	KSFT	Rs 4.00 - Rs 5.00

Source: PL Research

However, we need to keep a close watch on ITC's course of action in the coming days. At the same time, we believe that the cigarette industry would present its case before the ministry to reconsider duty on plains as the resultant duty on plains is higher than on RSFT.

For FY08, we believe that price hikes in micros and plains would face initial resistance among smokers and might result in volume loss for 15 days. Therefore, we have revised our volume estimates for FY08 from 1% volume decline to 3% volume decline resulting in an EPS revision from Rs 8.40 to Rs 8.35.

Valuation

We revise our earning estimate for FY08E from Rs8.40 to Rs8.35, for FY09E from Rs10.14 to Rs9.84 and for FY10E from Rs11.50 to Rs11.48. At the CMP of Rs193, the stock trades at 19.6x FY09E. We maintain Outperformer rating on the stock with a revised target price of Rs214.



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PL's Recommendation Nomenclature

BUY	: > 15% Outperformance to BSE Sensex	Outperformer (OP)	: 5 to 15% Outperformance to Sensex
Market Performer (MP)	: -5 to 5% of Sensex Movement	Underperformer (UP)	: -5 to -15% of Underperformance to Sensex
Sell	: <-15% Relative to Sensex		
Not Rated (NR)	: No specific call on the stock	Under Review (UR)	: Rating likely to change shortly

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