

ITC

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,086	ITC IN
	REUTERS CODE
S&P CNX: 2,945	ITC.BO

21 July 2006

Buy
Previous Recommendation: Buy
Rs167

Equity Shares (m)	3,723.3
52-Week Range	213/109
1,6,12 Rel. Perf. (%)	-1/8/15
M.Cap. (Rs b)	622.5
M.Cap. (US\$ b)	13.3

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
03/06E	97,905	22,807	6.1	24.2	27.3	6.8	25.1	33.5	5.9	17.4
03/07E	115,314	28,000	7.5	22.8	22.2	5.8	26.3	34.8	5.0	14.6
03/08E	136,198	32,911	8.8	17.5	18.9	5.0	26.4	35.1	4.1	12.3

- Revenues grew 25.7% due to strong growth across product segments. PAT for 1QFY07 increased 16.8% YoY as margins expanded in Cigarettes, Hotels and Paperboard. Excluding Rs195m gain (from the settlement with owners of Searock Hotel) in 1QFY06 numbers, PAT for 1QFY07 increased by 21.1% YoY.
- Cigarette revenues grew 11.1% YoY to Rs31.5b driven by mid-single digit volume growth. Other FMCG business grew 79.6% YoY to Rs3.6b. Hotel business was up 35.3% YoY to Rs1.99b. Agri- and Paper business grew 47.4% and 8.8% YoY respectively. Non-cigarettes business grew 44% and now accounts for 50.2% of net sales.
- 1QFY07 EBITDA margins declined 240bp YoY as sales contribution of loss-making and low-margin new FMCG and agri- businesses increased 590bp to 27.5%.
- We expect ITC to maintain healthy growth ahead due to strong business momentum in Cigarettes and Hotels. We expect Paper to continue the good showing due to benefits from stabilization of the new production line and rising sales of value-added Paperboard. Biscuits, Atta and Lifestyle retailing will likely drive growth in new FMCG business with turnaround likely by FY09.
- ITC plans to spend Rs150b on various expansion plans in next 7-10 years. This includes Rs50b investment plans in E-Choupal and Choupal Sagar. In addition, Hotels and Paperboard will be expanded, thus fueling long term growth. The stock is currently trading at 22.2x FY07E EPS and 18.9x FY08E EPS. We maintain **Buy**.

QUARTERLY PERFORMANCE

(Rs Million)

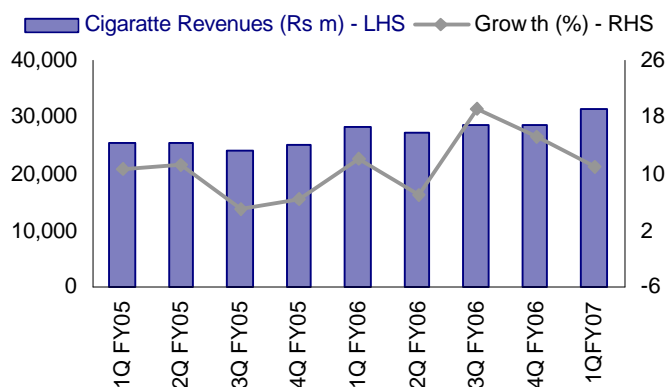
Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Net Sales	22,669	21,832	25,560	27,845	28,498	25,761	30,928	30,127	97,905	115,314
YoY Change (%)	24.7	22.2	37.5	27.9	25.7	18.0	21.0	17.9	28.2	17.8
Total Exp	14,401	13,633	16,777	19,820	18,792	16,100	20,350	20,842	64,632	76,084
EBITDA	8,268	8,198	8,783	8,024	9,706	9,661	10,578	9,285	33,274	39,230
Margins (%)	36.5	37.6	34.4	28.8	34.1	37.5	34.2	30.8	34.0	34.0
Depreciation	-801	-830	-831	-862	-876	-900	-900	-988	-3,323	-3,664
Interest	-11	3	-15	-97	-7	-6	-6	-6	-119	-25
Other Income	845	781	489	746	849	1,100	700	1,526	2,861	4,176
PBT	8,301	8,152	8,426	7,812	9,672	9,855	10,372	9,818	32,692	39,717
Tax	-2,718	-2,429	-2,603	-2,135	-3,149	-2,900	-3,150	-2,518	-9,885	-11,716
Rate (%)	32.7	29.8	30.9	27.3	32.6	29.4	30.4	25.6	30.2	29.5
Reported PAT	5,583	5,723	5,823	5,678	6,523	6,955	7,222	7,300	22,807	28,000
YoY Change (%)	20.1	17.3	24.8	36.0	16.8	24.6	26.2	25.4	24.1	22.8
Extraordinary Inc/(Exp)	195	0	454	4	0	0	0	0	450	0
Adjusted PAT	5,388	5,723	5,368	5,674	6,523	6,955	7,222	7,300	22,356	28,000
YoY Change (%)	15.9	17.3	15.0	-26.5	21.1	29.1	26.2	36.0	2.0	25.2

E: MOST Estimates

Cigarette growth accelerates

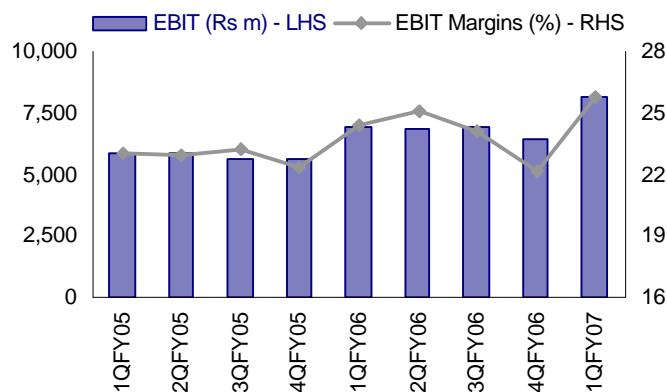
Cigarette revenues grew 11.1% YoY to Rs31.6b, driven by a mid-single digit volume growth coupled with product mix change and price increases (2.5%). Cigarette sales growth indicates much higher momentum on a YoY basis. Cigarette volumes are growing due rising affordability and relatively lower price increases by the companies in the past few years. PBIT margins for the quarter expanded by 140bp to 25.8%, showing the gains of rising volumes and better sales mix. The Cigarette business offers scope for sustained volume growth as cigarettes constitutes merely 14% of total tobacco consumed in the country. A growing number of users with multiple tobacco consuming formats is rising (currently 61%), which should continue to fuel demand for the product.

CIGARETTE-STRONG GROWTH MOMENTUM CONTINUES



Source: Company/ Motilal Oswal Securities

CIGARETTES-1QFY07 REPORTS HIGHEST EVER EBIT



Source: Company/ Motilal Oswal Securities

ITC - SEGMENTAL

	1QFY06	2QFY06	3QFY06	4QFY06	1QFY07
Sales Growth % (YoY)					
Cigarettes	12.0	7.2	19.1	15.1	11.1
FMCG - Others	90.4	87.1	71.2	75.7	79.6
Hotels	35.5	27.1	31.4	45.5	35.3
Agri business	64.2	15.5	63.1	55.8	47.4
Paper and packaging	22.1	21.9	25.3	15.5	8.8
EBIT Margin (%)					
Cigarettes	24.4	25.1	24.1	22.1	25.8
FMCG - Others	-27.3	-14.3	-15.1	-13.9	-16.2
Hotels	20.0	17.9	35.0	37.1	29.0
Agri Business	4.8	6.6	2.3	1.1	4.2
Paper and Packaging	19.4	19.5	18.7	16.5	20.9

Source: Company/ Motilal Oswal Securities

Processed food continues to power Other FMCG business growth

Other FMCG businesses grew 79.6% YoY during 1QFY07 even as EBIT losses increased by 6.4%. EBIT margin during current quarter was -16.2%, significantly lower than -27.3% recorded in 1QFY06. In addition to 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.

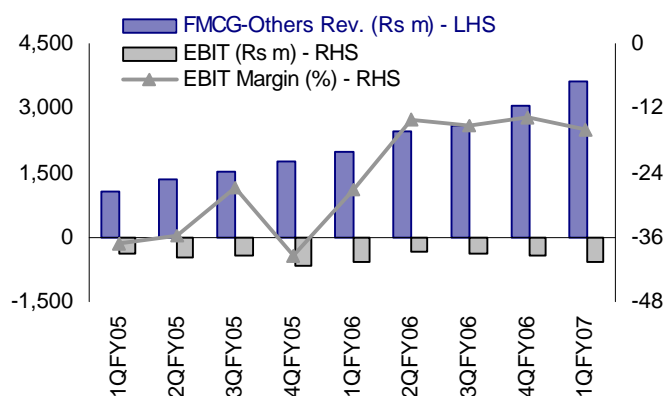
Food products continued to power growth with 62% YoY growth during 1QFY07. The business increased its distribution reach to more than 2m outlets in 85,000 markets. Sunfeast biscuits and Aashirvaad atta continue to be the largest contributors to sales with atta growing by more than 100% YoY during 1QFY07. ITC is undertaking aggressive initiatives to improve its positioning in the market:

- ✎ Introduction of **Sweet 'n Salt Crackers** as part of the Sunfeast range
- ✎ Own production facilities for biscuits across the country, including in tax-exempt zones (Haridwar under construction) , with a view to reducing costs and servicing proximal markets efficiently
- ✎ Value added variants of **Aashirvaad atta**, ITC increased price of Aashirvaad by 17% towards the end of the quarter, to cover additional costs arising from rising wheat prices
- ✎ Confectionery segment expanded with the launch of **Mango Natkhat** in the hard-boiled candy segment in June 2006.

➤ **Aashirvaad Instant Mixes** (Dosa, Khaman Dhokla, Gulab Jamun) introduced recently have been well received by consumers and extended to all target markets during the quarter.

We expect the branded foods business to continue growth momentum supported by differentiated products and innovation according to the tastes of the Indian consumer. We believe that ITC appears 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 backend provided by the E-Choupal network of the company.

FMCG-OTHERS: HIGH GROWTH CONTINUES



Source: Company/ Motilal Oswal Securities

Lifestyle retailing – All the major lifestyle brands such as **Classic, Wills Sport & Wills Clublife** maintained growth momentum driven by higher footfalls/conversion and improved realizations. **John Players** continued to create a buzz among its youthful target audience in the popular segment. ITC has expanded its distribution reach to 44 exclusive Wills Lifestyle and 95 John Players stores, in addition to its presence in 1,500 multi-brand outlets. The company plans to launch 8 new exclusive Wills Lifestyle stores in upcoming malls over the next 12 months. The future holds 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

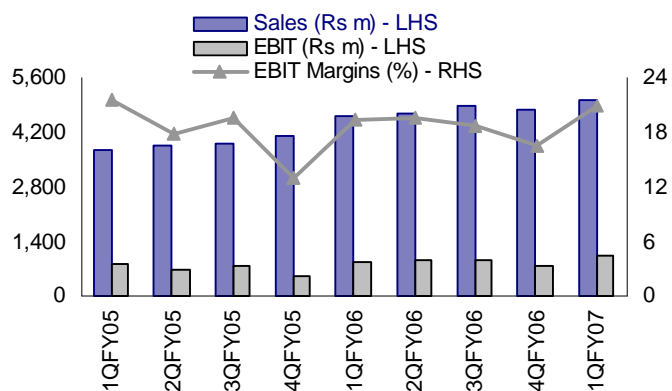
- Improving distribution network will increase the availability and boost sales
- ITC has been able to find the right product and brand mix with extensions into outwear, denims, premium and popular segments

E-Choupal and Choupal Sagar – huge investments in the pipeline

Agri-business reported 47.4% topline growth for 1QFY07 while PBIT increased by 29.7% as EBIT margin declined by 60bp. Growth was led by increased levels of soya trade and higher wheat sales to the company’s branded packaged foods business. EBIT margin declined due to incremental costs associated with scaling up of the e-choupal network and high base effect due to income from export incentives in 1QFY06.

The e-choupal network was further ramped up during 1QFY07 to 6,270 installations from 6,000 in March 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.

AGRI-BUSINESS: QUARTERLY PERFORMANCE TREND



Source: Company/ Motilal Oswal Securities

Rural retail initiative gained momentum with the launch of three more **Choupal Sagers** during the quarter. ITC now has 10 ‘Choupal Sagers’ operational in the three states of Madhya Pradesh, Maharashtra and Uttar Pradesh while nine more are in an advanced stage of construction. ITC plans to increase the number of Choupal Sagers to 40 in the coming 12-18 months. Existing Choupal Sagers continue

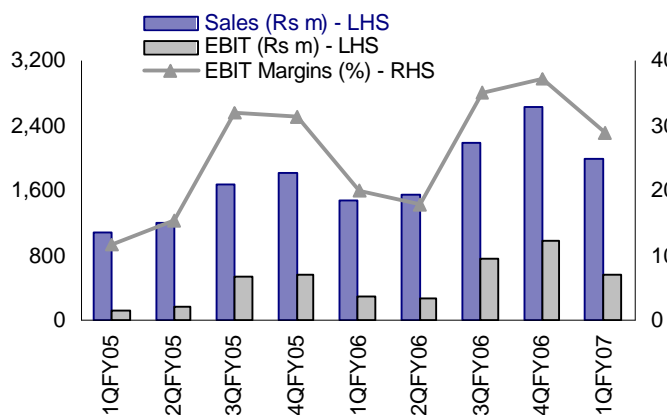
to ramp up well with rising customer affiliation and strong support from companies, which have identified e-choupal as a tool to enter the rural hinterlands.

The company has aggressive plans to expand the rural sourcing and distribution network in forthcoming years. ITC has announced its intention to scale up the e-choupal and Choupal Sagar networks to 20,000 and 700 respectively in 7-10 years covering over 100,000 villages with an investment of over Rs50b. Despite lower profit margins on a standalone basis, this initiative holds excellent long term value in synergistic combination with the branded foods and ITC's rural distribution strategy.

Hotels – boom times continues

Hotels business reported 35% increase in topline and 96% increase in PBIT as PBIT margins expanded by 900bp. Improvement in performance was on the back of improvement in occupancy levels and average revenue per room (ARR). The company has commenced the construction of a new super-deluxe luxury hotel at Bangalore while architectural planning has reached advanced stage for the proposed hotel at Chennai. 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 coming couple of years due to the long gestation nature of the industry.

HOTELS: QUARTERLY PERFORMANCE TREND



Source: Company/ Motilal Oswal Securities

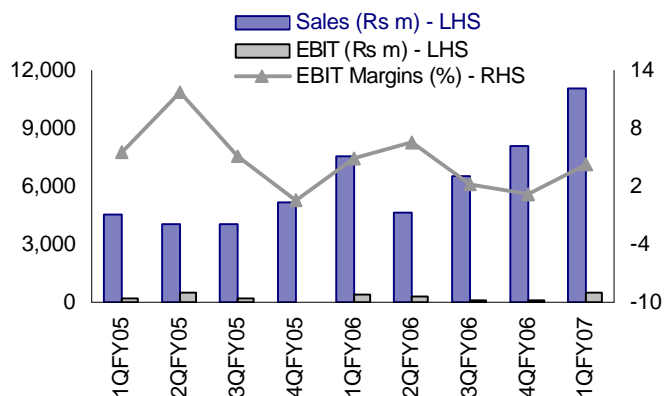
ITC has announced its intention to set up three hotels in Bangalore, one in Chennai and have a hotel in each state capital. The ensuing plans indicate that ITC's Hotel division will continue to enjoy healthy growth rates in the forthcoming years.

Paperboard - higher capacity utilization pays off

Paperboard division reported 8.8% sales growth and 16.8% EBIT growth as the EBIT margins expanded by 150bp. Increased capacity utilization at Kovai, benefits of captive power plant and 75,000 tpa capacity increase at Bhadrachalam, powered growth. Sales of value-added products touched 55% of total paper sales during the quarter.

The company expects demand for paperboard manufactured with ECF technology to grow at 20% due to rising demand from the Food and Pharma industries. Its ECF-based pulp unit will be expanded by 100,000 tonnes to cater to this rising demand. The company is also expanding capacity of its Cartons, Flexibles and Cigarette packaging unit to cater to growing demand of the new FMCG and Cigarette divisions.

PAPER BOARD AND PAPER: QUARTERLY PERFORMANCE TREND



Source: Company/ Motilal Oswal Securities

ITC currently fulfills 91% of its pulp wood requirements from its agro-forestry initiatives. The company has plans to increase the area under agro-forestry from 41,000 hectares to 100,000 hectares in forthcoming years to fulfill the rising demand for pulp wood. We expect Paper to report steady growth in sales and profits ahead. Growth rates are

expected to accelerate further once the company Rs25b greenfield project materializes.

Valuation and view

We expect the company to maintain strong growth in forthcoming quarters due to strong business momentum in Cigarettes and Hotels. We expect Paper to continue its good showing due to benefits from stabilization of its new production line and rising sales of value-added Paperboard. Biscuits, *Atta* and Lifestyle retailing will likely drive the

growth in new FMCG business with turnaround likely by FY09.

ITC plans to spend Rs150b on various expansion plans in the forthcoming 7-10 years. This includes plans to invest Rs50b in E-Choupal and Choupal Sagar. In addition, Hotels and Paperboard will be expanded in the coming years, thus fueling long term growth. The stock is currently trading at 22.2x FY07E EPS and 18.9x 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 Rs700m biscuit manufacturing facility in Uttaranchal.
- ✍ Launched new ready to eat foods and increased cigarette prices to neutralise impact of excise duty increase.

Valuation and view

- ✍ We forecast a 19% EPS CAGR over the next three years, driven by higher cigarette volumes and turnaround in the FMCG business.
- ✍ The stock is currently trading at 22.2x FY07E EPS and 18.9x FY08E EPS. We maintain **Buy**.

Sector view

- ✍ We are positive on the sector. The sector is showing strong volume growth across product categories with improving pricing power for leading players.
- ✍ Companies with low competitive pressures and brought product portfolios will be able to better with stand 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	22.2	31.9	27.9
	FY08E	18.9	25.3	22.7
EV/EBITDA (x)	FY07E	14.6	27.5	17.0
	FY08E	12.3	21.3	14.1
EV/Sales (x)	FY07E	5.0	4.2	3.7
	FY08E	4.1	3.6	3.3
P/BV (x)	FY07E	5.8	23.1	26.1
	FY08E	5.0	20.0	22.2

SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	0.0	0.0	0.0
Domestic Institutions	36.2	35.6	33.8
FIs/FDIs	49.0	49.1	53.5
Others	14.8	15.3	12.7

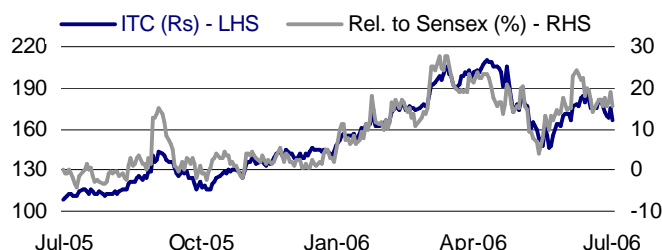
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	7.5	7.4	1.4
FY08	8.8	8.7	0.8

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
167	195	16.7	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT						(RS MILLION)					
Y/E MARCH	2004	2005	2006E	2007E	2008E						
Net Sales	64,456	76,044	97,905	115,314	136,198						
Change (%)	10.0	18.0	28.7	17.8	18.1						
Total Expenditure	-40,810	-48,098	-64,632	-76,084	-90,426						
EBITDA	23,646	27,947	33,274	39,230	45,772						
Change (%)	9.0	18.2	19.1	17.9	16.7						
Margin (%)	36.7	36.8	34.0	34.0	33.6						
Depreciation	-2,419	-3,129	-3,323	-3,664	-4,028						
Int. and Fin. Charges	-342	-508	-119	-25	-25						
Other Income - Recurring	2,293	2,411	2,861	4,176	4,963						
Profit before Taxes	23,179	26,721	32,692	39,717	46,682						
Change (%)	12.2	15.3	22.3	21.5	17.5						
Margin (%)	36.0	35.1	33.4	34.4	34.3						
Tax	-8,190	-7,879	-9,685	-12,511	-14,705						
Deferred Tax	928	-481	-200	794	934						
Tax Rate (%)	-31.3	-31.3	-30.2	-29.5	-29.5						
Profit after Taxes	15,917	18,361	22,807	28,000	32,911						
Change (%)	15.2	15.4	24.2	22.8	17.5						
Margin (%)	24.7	24.1	23.3	24.3	24.2						
Non-rec. (Exp)/Income	0	3,543	-450	0	0						
Reported PAT	15,917	18,361	22,356	28,000	32,911						

BALANCE SHEET						(RS MILLION)					
Y/E MARCH	2004	2005	2006E	2007E	2008E						
Share Capital	2,477	2,482	3,723	3,723	3,723						
Reserves	61,624	76,474	87,299	102,700	120,800						
Net Worth	64,101	78,956	91,023	106,423	124,524						
Loans	1,209	2,454	2,454	2,454	2,454						
Deferred Liability	877	3,761	4,407	5,201	6,135						
Capital Employed	66,187	85,171	97,883	114,078	133,112						
Gross Block	47,409	57,463	63,463	70,463	77,463						
Less: Accum. Depn.	-14,426	-17,955	-21,255	-24,919	-28,947						
Net Fixed Assets	32,983	39,508	42,208	45,543	48,515						
Capital WIP	3,137	1,862	5,000	12,000	22,000						
Investments	30,540	38,747	45,615	50,290	58,490						
Curr. Assets, L&A	34,854	35,393	41,890	49,584	56,016						
Inventory	15,342	20,030	24,311	30,316	35,489						
Account Receivables	2,302	5,278	6,776	7,898	8,582						
Cash and Bank Balance	340	557	933	1,195	1,453						
Others	16,870	9,529	9,870	10,175	10,492						
Curr. Liab. and Prov.	35,326	30,338	36,830	43,340	51,910						
Account Payables	28,043	18,920	23,098	26,705	32,520						
Other Liabilities	1,773	2,171	2,495	2,813	3,144						
Provisions	5,510	9,247	11,237	13,822	16,246						
Net Current Assets	-473	5,055	5,060	6,244	4,106						
Application of Funds	66,188	85,171	97,883	114,078	133,112						

E: MOST Estimates

RATIOS					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Basic (Rs)					
EPS	4.3	4.9	6.1	7.5	8.8
Cash EPS	4.9	5.8	7.0	8.5	9.9
BV/Share	17.2	21.2	24.4	28.6	33.4
DPS	13	2.1	2.4	3.0	3.5
Payout %	311	41.9	39.9	40.0	40.0
Valuation (x)					
P/E		33.9	27.3	22.2	18.9
Cash P/E		29.0	23.9	19.7	16.9
EV/Sales		7.7	5.9	5.0	4.1
EV/EBITDA		21.0	17.4	14.6	12.3
P/BV		7.9	6.8	5.8	5.0
Dividend Yield (%)		12	15	18	2.1
Return Ratios (%)					
RoE	24.8	23.3	25.1	26.3	26.4
RoCE	35.5	32.0	33.5	34.8	35.1
Working Capital Ratios					
Debtor (Days)	13	25	25	25	23
Asset Turnover (x)	10	0.9	10	10	10
Leverage Ratio					
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT						(RS MILLION)					
Y/E MARCH	2004	2005	2006E	2007E	2008E						
OP/(loss) before Tax	21,228	24,818	29,950	35,566	41,744						
Int./Div. Received	2,293	2,411	2,861	4,176	4,963						
Depreciation and Amort.	2,419	3,129	3,323	3,664	4,028						
Interest Paid	-342	-508	-119	-25	-25						
Direct Taxes Paid	-8,190	-7,879	-9,685	-12,511	-14,705						
(Incr)/Decr in WC	4,698	-5,311	371	-922	2,396						
CF from Operations	22,105	16,660	26,701	29,948	38,401						
(Incr)/Decr in FA	-6,391	-8,777	-9,139	-14,000	-17,000						
(Pur)/Sale of Investments	-14,451	-8,207	-6,869	-4,674	-8,200						
CF from Invest.	-20,842	-16,985	-16,006	-18,673	-25,199						
Issue of Shares	12	872	0	0	0						
(Incr)/Decr in Debt	38	-150	-149	-149	-149						
Dividend Paid	-5,588	-8,792	-10,244	-12,600	-14,810						
Others	726	8,602	74	1,736	2,015						
CF from Fin. Activity	-4,712	532	-10,319	-11,013	-12,944						
Incr/Decr of Cash	-3,449	207	376	262	258						
Add: Opening Balance	3,788	340	557	933	1,195						
Closing Balance	340	547	933	1,195	1,453						



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	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

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