

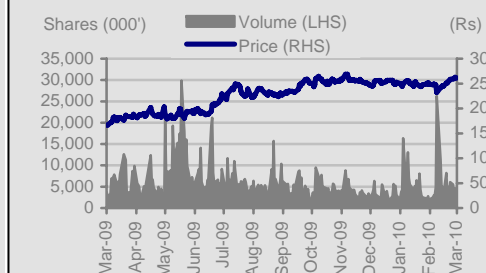
## State VAT hike fears fade away

- The blended VAT rate on cigarettes has increased by only 60-70bps for ITC, with almost all large states' budget presentations having been presented.
- This increase is much lower than the worst-case scenario of a 600bps blended hike in cigarette VAT.
- ITC has already taken a blended 10-11% price hike, more than the 7-8% needed to offset the increase in excise duty.
- The YoY price increase on ITC's cigarette portfolio for June quarter 2010 would be 13-14%, as the company took a number of price hikes only after June 2009.
- The company could raise prices further through the year and surprise on EBIT growth in cigarettes. We reiterate BUY.
- **West Bengal, Kerala, Tamil Nadu leave VAT unchanged:** States accounting for a substantial proportion of ITC's cigarette sales—Kerala, West Bengal and Tamil Nadu—have left the VAT rate unchanged at 12.5%.
- **Modest increase by Andhra Pradesh, Karnataka, Gujarat and MP:** There have been modest 1-3% increases in cigarette VAT by Karnataka, Gujarat and Andhra Pradesh.
- **Blended rate is up only 60-70bps, significantly lower than the worst-case scenario of 600bps:** These increases will lead to a 60-70bps increase in the blended VAT rate for ITC, from c14% in FY10 to just over 14.5% in FY11. This increase is significantly lower than the worst-case scenario—all states raising VAT rate on cigarettes to 20%, in line with in the VAT rate set by states like Maharashtra last year.
- **YoY price increase for June quarter 2010 will be c14%:** ITC took a 10-11% price hike after the budget. However, compared with prices in the June quarter of 2009, there is a c14% increase in prices, as many price hikes last year came after the June quarter. As such, we expect ITC to report strong EBIT growth in cigarettes in the June quarter.
- **ITC could take more hikes in 2HFY11:** ITC could take further price hikes in 2HFY11 and surprise on cigarette EBIT growth for FY11 as compared to our estimate of 10% growth.

<b>CMP</b>	<b>Rs261</b>
<b>12-mth Target price (Rs)</b>	<b>276</b>
<b>Market cap (US\$ m)</b>	<b>21,606</b>
<b>Bloomberg</b>	<b>ITC IN</b>
52Wk High/Low (Rs)	271/167
Diluted o/s shares (m)	3809
Daily volume (US\$ m)	26
Dividend yield FY10ii (%)	2.0
Free float (%)	100.0
<b>Shareholding pattern (%)</b>	
BAT	32.0
FII's	12.8
DII's	37.9
Others	17.3

<b>Price performance (%)</b>	<b>1M</b>	<b>3M</b>	<b>1Y</b>
ITC	5.2	5.8	53.9
Rel. to Sensex	-3.4	0.7	-41.3
Britannia	-3.1	-3.2	21.5
HUL	-5.0	-13.1	-0.6
Nestle India	0.2	4.8	73.5

### Stock Performance



### Financial Summary

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenues (Rs m)	139,475	153,881	177,234	199,446	228,468
EBITDA Margins (%)	31.6	31.6	35.0	34.7	35.1
Reported PAT (Rs m)	31,201	32,636	41,297	46,056	53,715
Adj. EPS (Rs)	8.3	8.6	10.9	12.2	14.2
Growth (%)	15.6%	4.3%	26.4%	11.5%	16.6%
<b>PER (x)</b>	<b>31.5</b>	<b>30.2</b>	<b>23.9</b>	<b>21.4</b>	<b>18.4</b>
ROE (%)	25.9	23.8	26.5	26.1	26.8
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0
<b>EV/EBITDA (x)</b>	<b>22.3</b>	<b>20.1</b>	<b>15.7</b>	<b>14.0</b>	<b>11.8</b>
Price/Book (x)	8.2	7.2	6.3	5.6	4.9

Source: IIFL Research, Priced as on 22 March 2010

**Figure 1: Most states have kept VAT unchanged, or given modest hikes**

State	Cigarette VAT ( FY10)	Cigarette VAT ( FY11)
Maharashtra, Haryana, Delhi, Pondicherry, Rajasthan	20.0%	20.0%
Andhra Pradesh, Chhattisgarh	12.5%	14.5%
Gujarat, Karnataka	12.5%	15.0%
Kerala	12.5%	12.5%
Tamil Nadu	12.5%	12.5%
West Bengal	12.5%	12.5%
Bihar	12.5%	12.5%
MP	12.5%	13.5%
Blended All India	13.9%	14.5%

Source: Industry sources, IIFL Research

**Figure 2: YoY blended price hike over June quarter 2009 is 13-14% for ITC's cigarette portfolio**

Brand (pack size)	Price			Price hike	
	Jun-09	Feb-10	Mar-10	Over June 2009	Over Feb 2010
Gold Flake Premium (10)	29.0	29.0	29.0	0.0%	0.0%
Gold Flake Regular Filter (10)	30.0	30.0	35.0	16.7%	16.7%
Navy Cut (10)	34.0	34.0	40.0	17.6%	17.6%
Bristol (10)	19.0	23.0	25.0	31.6%	8.7%
Classic (20)	88.0	98.0	100.0	13.6%	2.0%
Gold Flake Filter Kings (10)	44.0	47.0	48.0	9.1%	2.1%
Scissors (10)	20.0	20.0	25.0	25.0%	25.0%
Capstan (10)	19.0	19.0	19.0	0.0%	0.0%
Blended for ITC's cigarettes				13-14%	10-11%

Source: Industry sources, IIFL Research

**We reiterate BUY; cigarette volume growth surprise would be the next trigger for the stock**

With VAT rate increase being significantly lower than the worst-case scenario, we believe visibility of double-digit EBIT growth for ITC has improved. With no more price hikes needed, growth in ITC's cigarette volumes may well beat our current estimate of c3%. Any positive surprise in cigarette volume growth would be the next trigger for the stock. Our SOTP-based target price is Rs276. We reiterate BUY.

### Key to our recommendation structure

**BUY** - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.

**SELL** - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

**Add** - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.

**Reduce** - Stock expected to return less than the hurdle rate, ie return of less than 10%.

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