Macquarie Research
Equities

INDIA

ITC Ltd

9 April 2007

ITC IN		Outperform
Stock price as of 09 Apr 07	Rs	155.35
12-month target	Rs	195.00
Upside/downside	%	+25.5
30-day avg turnover	US$m	29.8
Market cap	US$m	13,697
BSE Sensex as of 09 Apr 07		13,195

Investment fundamentals

Year end 31 Mar		2006A	2007E	2008E	2009E
Revenue	bn	102.9	120.8	129.8	150.6
EPS adj	Rs	6.10	7.14	6.74	7.85
EPS adj growth	%	-13.4	17.1	-5.6	16.3
PE adj	x	25.5	21.8	23.0	19.8

Inside

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Clearing the smoke!

Initiating coverage: 26% potential upside to target price

We initiate coverage on tobacco giant ITC with an Outperform recommendation. We believe ITC will overcome the pain of rising taxes in FY08 and emerge as an attractive low-risk play on the domestic consumption story. Our DCF-based target price of Rs195 (26% potential upside) implies a target forward PER of 25x.

Market pessimism on value-added tax is overdone

ITC underperformed the Sensex over the last four months, due to uncertainty regarding the VAT on cigarettes, which contribute 80% of profits. A 12.5% VAT has been proposed in three state budgets; we expect the remaining 25 states to follow suit.

Worst-case scenario currently priced in: Our analysis shows that the market is pricing in the worst-case scenario that ITC would be able to pass the impact of the VAT onto consumers only over 3–4 years. However, we forecast a repeat performance of 2002, when ITC was able to pass on a 17% effective tax hike over 18–24 months. We expect the first phase of the price hikes, ie, 5–10% for ITC's higher-priced brands, to come through in the next two months.

Limited exposure to key headwinds faced by the market

ITC is a strong defensive play due to limited operational exposure to three key risks: a slowdown in the US economy, rising interest rates and softening commodity prices. ITC is instead a play on a bullish sub-plot emerging in India: the consumption boom, driven by emerging demographic trends.

Return on investments to reduce exposure to cigarettes

Investments beginning to kick in: Solid cashflows from the cigarette business have allowed ITC to invest US$550m (~75% of total capex) in long-gestation, high-return businesses, such as hotels, paper and agribusiness, over the last five years. The contribution of cigarettes to EBIT has fallen from 90% to 80% over the last three years. We forecast this would fall further to 66% over the next five years, driven by a projected 31% profit CAGR for the non-cigarette businesses.

Expect 20% earnings CAGR from FY09: Cigarette prices have outpaced tax hikes consistently in the last decade. We expect this trend to resume from FY09. We forecast a 31% profit CAGR for non-cigarette ventures over the next five years, driven by a turnaround in FMCG and hotel room demand buoyed by supply constraints. This is likely to drive 20% overall earnings CAGR from FY09. As consensus factors the VAT into estimates, we expect to stand 5% above consensus for FY09E.

Sweet spot in free cashflow: We estimate that ITC will have a war chest of US$400m in two years. We rule out special dividends based on our observations. Fundamentally, we like the idea of investments in FMCG. Experience from the hotel and paper ventures tells us that this could yield 20% RoCE over 3–5 years.

Multiples poised to recover

The revised regulation removes a key overhang, which recently drove ITC's PER premium (relative to the Sensex) to 5% vs the long-term average of 22%. Additionally, we expect the rising profit contribution of non-cigarette ventures to drive PER upwards by 10%, towards the level of Indian consumer peers.

ITC IN **Outperform**

Stock price as of 09 Apr 07	Rs	155.35
12-month target	Rs	195.00
Upside/downside	%	+25.5
Valuation	Rs	195.00
- DCF (WACC 11.9%)		
GICS sector		food beverage & tobacco
Market cap	Rs m	584,461
Market cap	US$m	13,697
Number shares on issue	m	3,762

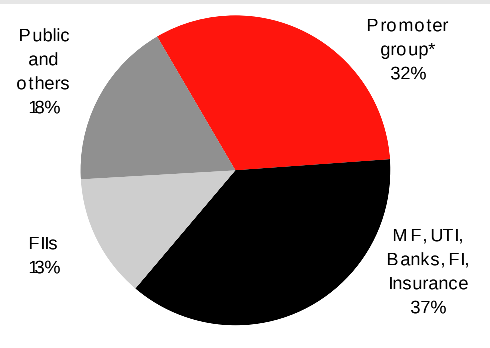
Investment fundamentals

Year end 31 Mar		2006A	2007E	2008E	2009E
Total revenue	bn	102.9	120.8	129.8	150.6
EBITDA	bn	34.3	39.4	36.9	42.8
EBITDA growth	%	18.7	14.9	-6.4	16.1
Reported profit	bn	23.0	26.8	25.3	29.5
Adjusted profit	bn	22.9	26.8	25.3	29.5
EPS rep	Rs	6.11	7.14	6.74	7.85
EPS rep growth	%	-32.1	16.8	-5.6	16.3
EPS adj	Rs	6.10	7.14	6.74	7.85
EPS adj growth	%	-13.4	17.1	-5.6	16.3
PE rep	x	25.4	21.8	23.0	19.8
PE adj	x	25.5	21.8	23.0	19.8
Total DPS	Rs	3.03	3.54	3.36	3.91
Total div yield	%	2.0	2.3	2.2	2.5
ROE	%	26.7	27.1	22.6	23.4
EV/EBITDA	x	15.6	13.6	14.5	12.5
Net debt/equity	%	-39.8	-46.2	-53.0	-51.2
Price/book	x	6.3	5.5	4.9	4.4

ITC IN rel SENSEX performance, & rec history

Source: Datastream, Macquarie Research, April 2007 (all figures in INR unless noted)

Shareholding pattern (December 2006)

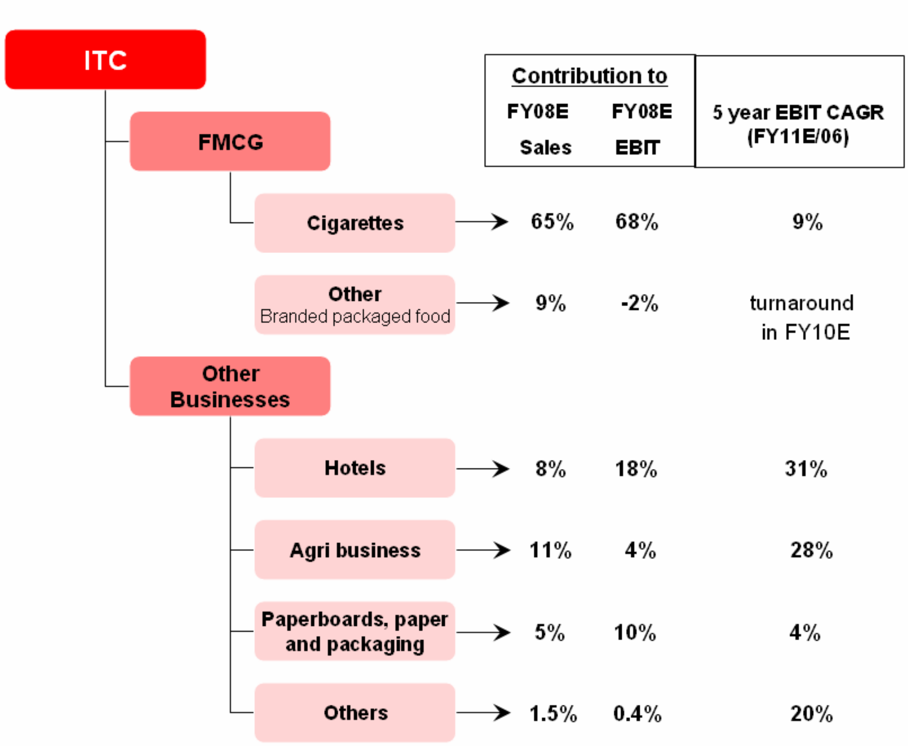


* British American Tobacco (BATS LN, Not rated)

Source: Macquarie Research, April 2007

ITC Ltd

Fig 1 Company profile

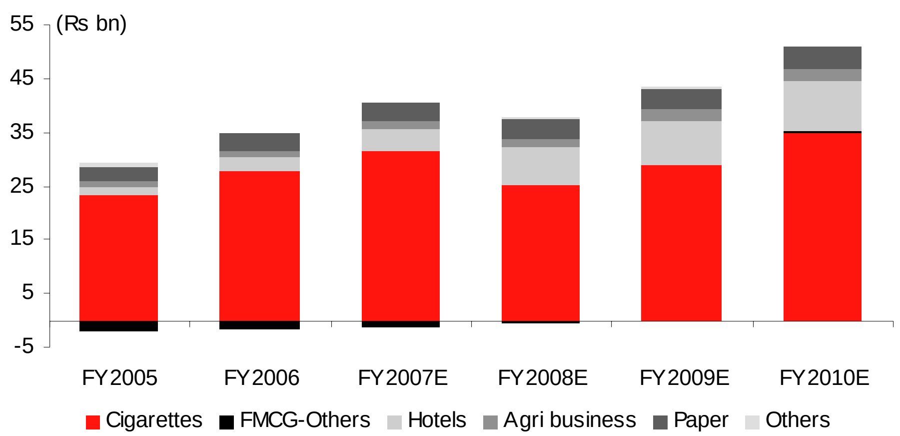


Source: Company data, Macquarie Research, April 2007

Key brands include:

- **Cigarettes:** Wills, Gold Flake, Bristol and Capstan
- **Food:** Aashirvaad flour/salt/spices, Sunfeast biscuits
- **Confectionery:** Candyman, Mint-o
- **Ready-to-eat:** Kitchens of India, Aashirvaad ready meals, Sunfeast Pasta

Fig 2 EBIT breakdown – cigarette business the primary driver



Source: Company data, Macquarie Research, April 2007

Clearing the smoke!

Initiating coverage: 26% potential upside to target price

We initiate coverage on tobacco giant- ITC with an Outperform recommendation. We believe ITC will overcome the pain of rising taxes in FY08 and emerge as an attractive low-risk play on the domestic consumption story. Our DCF-based target price of Rs195 (26% potential upside) implies a target forward PER of 25x.

Market pessimism on value-added tax is overdone

ITC has underperformed the market index (BSE Sensex) over the last four months by ~19%. This was driven by uncertainty regarding the regulation and implementation of ad-valorem valued-added tax (VAT) on cigarettes, which contribute 80% of ITC's profits. A 12.5% VAT has been proposed in three state budgets; we expect the remaining 25 states to follow suit.

Market is pricing in the worst-case scenario: Our scenario analysis shows that the market is pricing in a scenario whereby ITC would be able to pass the full impact of the VAT onto consumers only over 3–4 years. We believe this is too pessimistic and forecast a repeat performance of 2002, when ITC was able to pass on a 17% effective hike in tax over 18–24 months. We expect the first phase of price hikes, ie, 5–10% for ITC's higher-priced brands, to come through in the next two months. This should help ITC tide over weak volumes in FY08E and return to normalised profit growth of 20% CAGR over three years.

Possibility of additional 5% upside: We believe that the government would not want to negatively impact cigarette-related tax collections. This gives rise to a distinct possibility that the hike in excise duty or VAT on cigarettes in FY09 would be limited. We also do not rule out the possibility of tax incentives (such as a partial roll-back of excise) to offset the impact of the VAT. In such case, there should be further 5% upside potential for ITC shareholders.

Limited exposure to key headwinds faced by the market

ITC circumvents three key risks faced by the Indian markets. The Indian market indices are currently exposed to three prominent risks, which make investors nervous.

⇒ A slowdown in the US economy.

⇒ Rising interest rates.

⇒ Softening of commodity prices.

ITC's operations have minimal exposure to these risks, making it a strong defensive play against these factors.

Direct play on strong domestic economic growth. ITC is well placed to benefit from the two bullish sub-plots emerging in the Indian economy.

⇒ The imminent 'great Indian consumption boom', driven by emerging demographic trends, eg, growth in the number of households earning >US$5,000 annually.

⇒ Improving supply chain/logistics efficiencies due to investments in infrastructure.

Return on investments to reduce exposure to cigarettes

Investments beginning to kick in: Solid cashflows from the cigarette business have allowed ITC to invest US$550m (~75% of total capex) in long-gestation, high-return businesses over the last five years. We believe returns from investments in the fast-growing hotels, paper and agribusiness ventures have begun to have a material earnings impact. In fact, the contribution of cigarettes to EBIT has fallen from 90% to ~80% over the last three years. We forecast this will continue to fall to 66% over the next five years, driven by a projected 31% profit CAGR for the non-cigarette businesses. This should help provide resilience and impetus to the bottom line.

Expect 20% earnings CAGR from FY09E: Cigarette prices have outpaced tax hikes consistently in the last decade. We expect this trend to resume from FY09. We forecast a 31% profit CAGR for the non-cigarette ventures over the next five years. We expect this to be driven by a turnaround in the non-cigarette FMCG businesses and robust demand for hotel rooms, due to strength in the economy and supply constraints. This is likely to drive 20% overall earnings CAGR over three years from FY09E. As consensus factors in the VAT into earnings estimates, we expect to stand 5% above consensus for FY09E.

Sweet spot in free cashflow: We estimate that ITC will have US$400m of unutilised cash over the next two years after accounting for planned capex and (normal) dividends. Based on the company's history, we rule out the possibility of special dividends and buybacks. Fundamentally, we like the idea of using this war chest for investments in the FMCG space. Experience from the hotel and paper ventures tells us that this could yield 20% RoCE over 3-5 years.

Multiples poised to recover

The revised regulation removes a key overhang, which was responsible for driving ITC's PER premium (relative to the Sensex) to 5% over the last four months vs the long-term average of 22%. We also expect the rising profit contribution of the non-cigarette ventures to drive PER upwards by 10%, towards the level of its Indian consumer peers.

Valuations – 26% upside to target price

ITC shares currently trade at a PER of 23x FY08E EPS. However, we note that FY08E will be the first year when the company will feel the pain of the VAT implementation. We forecast that ITC will resume normalised earnings growth of 20% CAGR over three years from FY09E. Additionally, FY08E multiples do not capture the growth potential of the other businesses, such as hotels, paper, other FMCG and agribusiness. We believe these factors are more accurately captured by our DCF-based valuation approach (Figure 3).

Our target price of Rs195 provides 26% potential upside from the current price.

Fig 3 Snapshot of valuation

(A) Cashflow till 2013		**WACC calculation**	
Total PV of free cash flow till 2013 (Rs m)	157,817	Risk-free rate	8.25%
		Market risk premium	7.0%
(B) Cashflow from 2014 to 2020	-	Total market return	15.3%
Growth rate from 2014 to 2020	12.0%	Beta (x)	0.93
		Cost of equity	14.8%
NPV of FCF as at 2014 (Rs m)	430,218	Gross cost of debt	10.0%
PV of free cashflow from 2014 to 2020 (Rs m)	195,738	Tax rate	33.9%
		Net cost of debt	6.6%
(C) Terminal value calculation		Debt/capital ratio	35%
Terminal growth rate from 2020	4.0%	**WACC**	**11.9%**
FCF in FY2020 (Rs m)	135,419		
Exit PER multiple (X)	13.2	Total company value (A) + (B) + (C) (Rs m)	722,232
Terminal value (Rs m)	1,781,045	Net debt/ (cash) (Rs m)	(8,311)
		Value to equity holders (Rs m)	730,543
PV of terminal value (Rs m)	368,677	Value to equity holders (Rs/share)	**195**

Source: Macquarie Research, April 2007

Fig 4 Sensitivity of our target price to changes in the risk-free rate

Risk-free rate	7.25%	7.75%	**8.25%**	8.75%	9.25%
Target price (Rs/ share)	217	205	**195**	185	176

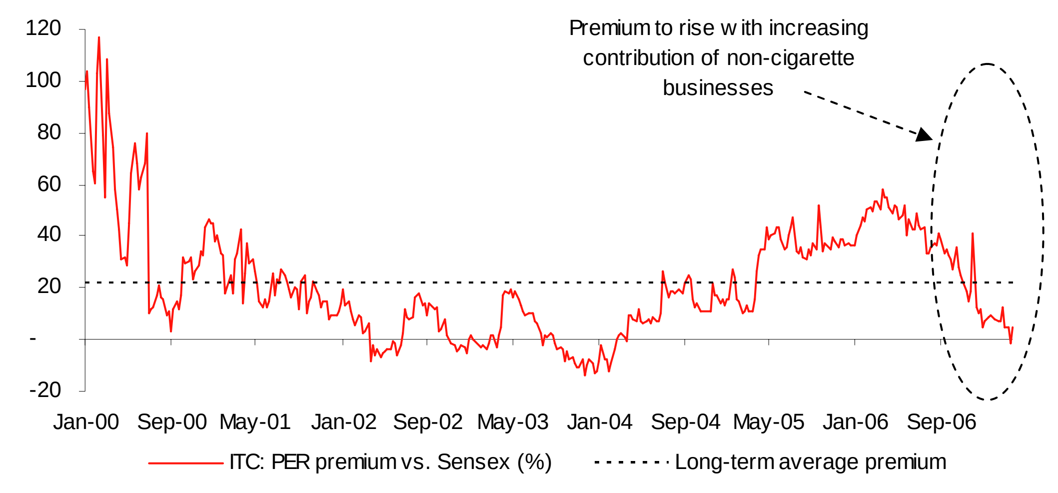
Source: Macquarie Research, April 2007

Multiples poised to recover

Relative valuation below long-term average

ITC has historically traded at an average PER premium of ~22% relative to the Sensex. However, the premium has fallen to 5%, way below the long-term average over the last four months, due to the regulatory/VAT overhang (Figure 5).

Fig 5 Tax overhang has impacted ITC's PER premium relative to Sensex (%)



Source: Bloomberg, Macquarie Research, April 2007

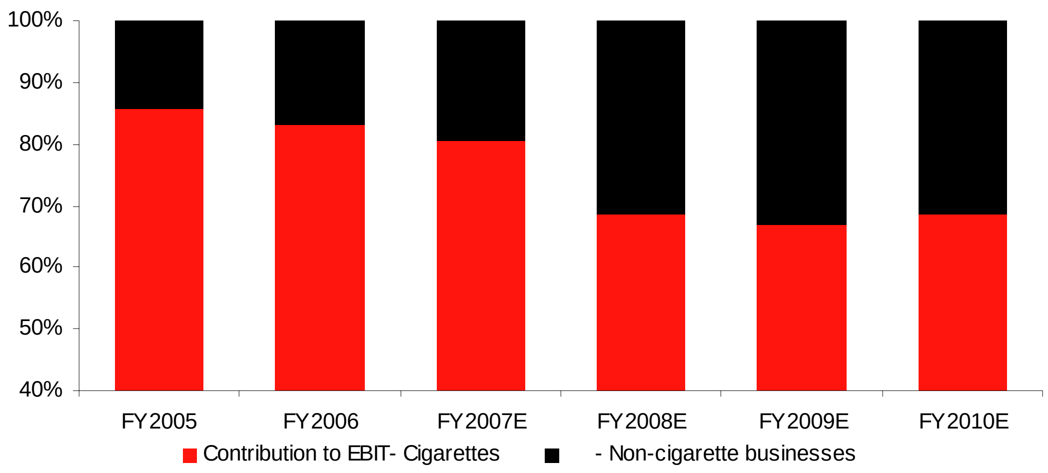
Revised regulation removes a key overhang

We believe the recent announcement of the new regulation is an important event as it removes a key overhang and signals a return of earnings visibility for ITC. In our view, this would help drive ITC's PER premium (relative to the Sensex) towards and above the long-term average.

ITC PER to rise towards domestic consumer peers'

Additionally, we expect ITC's non-cigarette ventures to increasingly contribute to and drive overall profits (Figure 6). In fact, the contribution of cigarettes to EBIT has fallen from 90% to ~80% over the last three years. We forecast this to continue falling to ~65% over the next five years, driven by a projected 31% profit CAGR for these businesses.

Fig 6 EBIT breakdown – rising contribution of non-cigarette businesses



Source: Company data, Macquarie Research, April 2007

We believe this will drive ITC's PER upwards by 10% to move in line with those of its Indian consumer sector peers (Figure 7). These factors are likely to help ITC command a premium PER vs the market index (Figure 5).

Fig 7 ITC – tobacco peers and domestic consumer sector peer group valuations

Company	Market Cap (US$m)	2-yr fwd EPS CAGR (%)	EBIDTA Margin (FY06) (%)	PAT Margin (FY06) (%)	Trailing PER (x)	Fwd PER (FY07E) (x)	Fwd PER (FY08E) (x)	PEG ratio @
Global tobacco peer group average	23,442	7	17.6	17.6	19.1	17.1	15.6	2.1
Regional tobacco peer group average	13,153	11	17.3	12.5	20.5	18.1	17.1	3.3
Indian tobacco peer group average	155	n/a	11.4	11.4	13.1	n/a	n/a	n/a
Indian consumer peers								
Hindustan Lever	10,464	-1	15.2	15.2	23.8	28.0	24.5	nm
Nestle	2,360	13	12.5	12.5	32.7	29.7	25.5	2.2
Colgate-Palmolive	1,075	28	12.4	12.4	33.0	24.4	20.2	0.9
Tata Tea	855	7	9.6	9.6	11.7	11.2	10.2	1.6
Dabur	1,865	21	12.5	12.5	35.0	28.8	23.9	1.4
Britannia	684	12	8.6	8.6	20.1	18.0	16.0	1.5
Marico	905	34	7.7	7.7	42.6	30.4	23.6	0.9
Godrej Consumer	792	21	17.3	17.3	28.0	23.6	19.1	1.1
GlaxoSmithKline Consumer	502	19	11.0	11.0	20.7	17.0	14.5	0.9
Average	**2,167**	**17**	**11.9**	**11.9**	**27.5**	**23.5**	**19.7**	**1.3**
ITC Ltd*	**13,697**	**9**	**33.3**	**22.5**	**25.5**	**21.8**	**23.0**	**2.5**
ITC (normalised)**		**20**						**1.1**

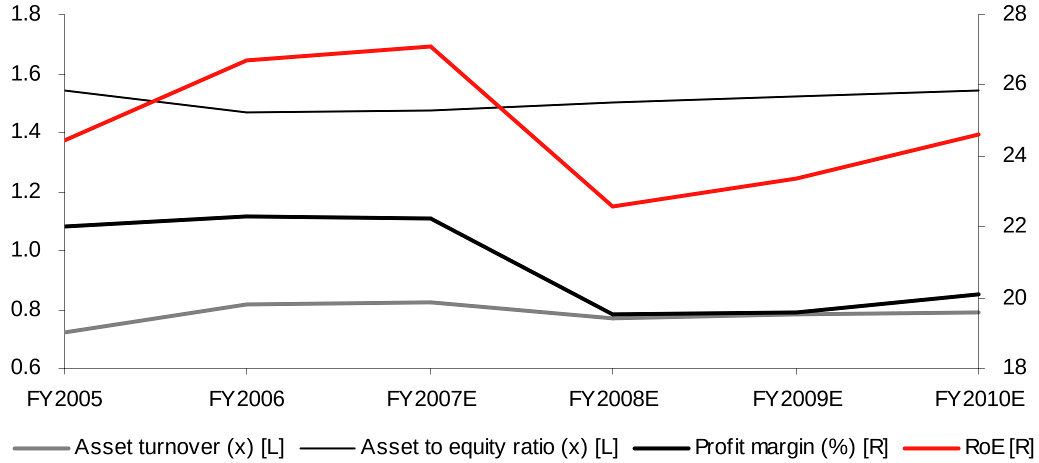
Source: Bloomberg, Macquarie Research, April 2007

Sustained stock outperformance due to rising earnings and ROE from FY09E

We forecast that ITC will overcome the near-term pain of VAT implementation in FY08 and subsequently resume normalised earnings CAGR of 20%. As a result, we estimate ROE to see a sustainable increase from FY09 (Figure 8) and believe that these factors will lead to sustained stock outperformance.

This also justifies our target PER multiples of 25x (FY09E) EPS and 21x (FY10E) EPS.

Fig 8 ROE to grow sustainably after overcoming the pain of VAT in FY08E

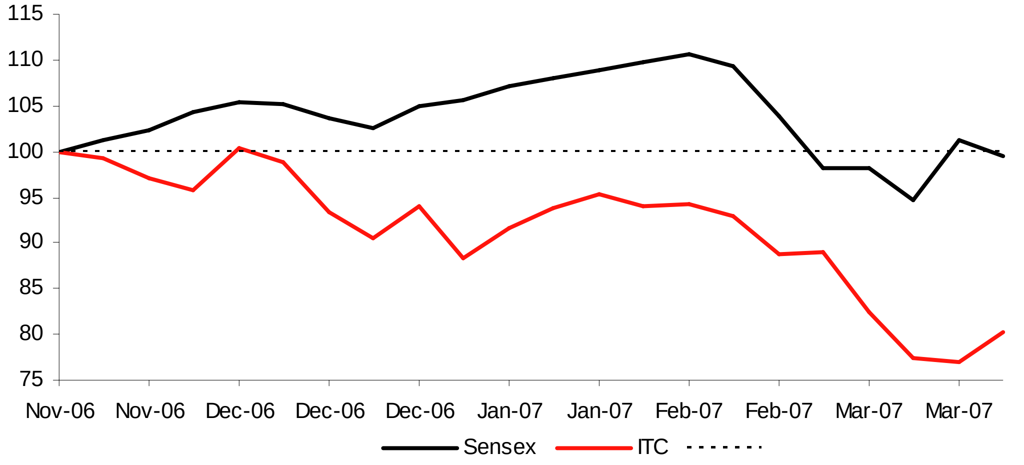


Source: Macquarie Research, April 2007

Market pessimism on VAT is overdone

The last four months have seen significant newsflow and speculation regarding cigarette tax laws. Cigarettes contribute ~80% of ITC's profits, and ad-valorem VAT has been slapped on cigarettes, in addition to already existing fixed (basic and additional) excise duties. The overhang of uncertainty regarding the regulation and implementation (ie, timing and quantum) of VAT has resulted in ~19% underperformance by ITC shares relative to the market index (BSE Sensex).

Fig 9 ITC – recent underperformance driven by regulatory overhang



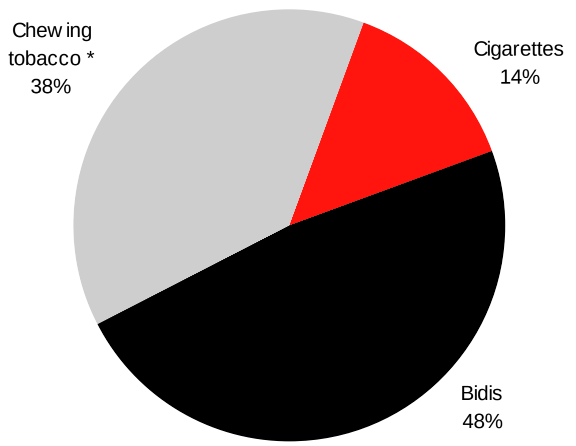
Source: Bloomberg, Macquarie Research, April 2007

It's official – VAT is here to stay

History of cigarette taxation in India

Tobacco consumption in India is dominated by traditional products such as '*biris*', '*gutkha*' and chewing tobacco. This accounts for 85% of consumption (Figure 10), with cigarettes making up only 15%. However, cigarettes are taxed ~35 times more than other tobacco products (for equal weight) in India. In fact, >50% of the price of cigarettes is tax. As a result, cigarettes contribute 85% of tobacco products revenue (Figure 11).

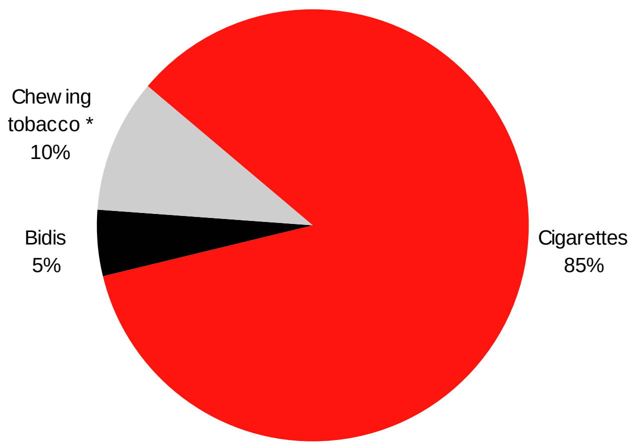
Fig 10 Cigarettes – small proportion of consumption**



* Gutkha, Zarda, Khaini, etc

Source: Godfrey Phillips, Tobacco Institute of India, Macquarie Research, April 2007

Fig 11 …but contribute bulk of tobacco revenues



** Consumption indicates number of units consumed

Source: Godfrey Phillips, Tobacco Institute of India, Macquarie Research, April 2007

The constitution did not allow implementation of VAT

Prior to 2006, cigarettes were classified as ‘declared goods’ under the Additional Duties of Excise (Goods of Special Importance) Act, 1957. This meant that state governments could not levy VAT on tobacco at a rate higher than the 4% applicable on declared goods. Instead, a fixed AED (Additional Excise Duty, ie, in addition to the basic excise duty) was collected from manufacturers, which was then distributed to the states based (broadly) on population.

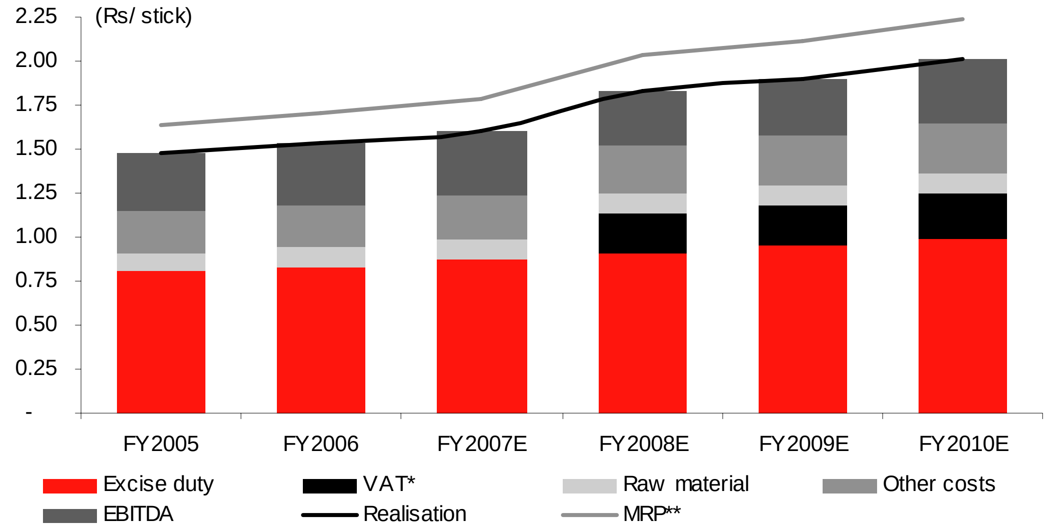
In late 2006, some state governments pitched to the central government to allow them to amend the constitution and implement VAT on cigarettes. They proposed to introduce the Taxation Laws (Amendment) Bill, 2007 in the budget session of parliament, which proposed to drop cigarettes from the list of ‘declared goods’ and amend the Additional Duties of Excise (Goods of Special Importance) Act, 1957 to enable this.

The CII recommended that cigarettes be kept out of the VAT net

The Confederation of Indian Industry (CII) recommended that cigarettes be kept out of the purview of VAT in its pre-budget memorandum submitted to the government. The primary arguments were:

- Cigarettes are a finished product. About 90% of the value is added at the manufacturing stage with 2% at the wholesale and 8% at the retail stage (Figure 12). It is estimated that 60% of cigarette sales is through the road-side ‘*paan*’ sellers along with ~10-15m retail outlets. This would mean that implementation of VAT would significantly increase the cost of collection.

Fig 12 90% of the value added in cigarettes is at the manufacturing stage



* Includes only VAT paid by ITC ** Includes VAT on wholesale and retail

Source: Company data, Industry sources, Macquarie Research, April 2007

- AED is distributed based on population weight. Some of the most populous states in India are also the poorest in terms of per-capita GDP. Cigarettes attract higher tax and cost much more than other tobacco products. This results in lower consumption of cigarettes per capita in these states. This implies that if VAT is implemented, these states would lose revenue in comparison with their share of AED.
- States may impose differential VAT, which would create differences in the invoice prices between wholesales and retailers. This would encourage inter-state smuggling.
- Since cigarettes are highly taxed, tax evasion by dealers via off-book transactions is possible, which would erode tax collection.
- About >50% of the price of cigarettes goes into tax payments. A state VAT on cigarettes is a cascading tax. This had also prompted Mr Vijay Kelkar, chairman of the Task Force on Indirect Taxes, to comment in 2002 that "VAT on cigarette would chiefly be a tax on excise". The task force had also recommended that cigarettes should remain within the control of the central government vs giving way to the states to impose VAT.

On 20 March 2007, laws were amended, clearing the way for VAT on cigarettes

The 12th Finance Commission's report in 2004 recommended that tobacco should be integrated into the system of state VAT. Despite the contrary views of industry and the CII, the Taxation Laws (Amendment) Bill, 2007 was passed and the Additional Duties of Excise (Goods of Special Importance) Act, 1957 amended on 20 March 2007. As a result:

- Tobacco no longer figures in the list of 'declared goods'.
- This allows states to levy VAT higher than 4%.

Note that the VAT is in addition to the 5% hike in central excise duty through the union budget (announced on 28 February 2007). FY08 will therefore see a double tax impact on cigarettes (and ITC).

- A 5% hike in excise duty by the central government.
- A 12.5% VAT on cigarettes imposed by state governments.

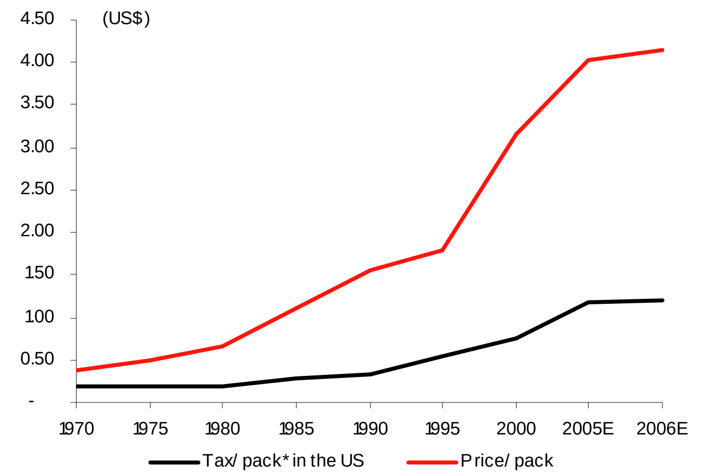
The 12.5% VAT has been proposed in three state budgets, and we expect the remaining 25 states to follow suit.

ITC is best placed to pass tax hikes onto consumers

Taxes are passed on consistently due to inelastic demand

Due to the strong habit-forming nature of cigarettes, it has been observed that demand (across countries) is fairly inelastic. In fact, cigarettes are frequently used as an example of inelastic demand in economic textbooks. Figures 13 and 14 highlight this fact and show how tax hikes in the US and India have been consistently passed onto consumers.

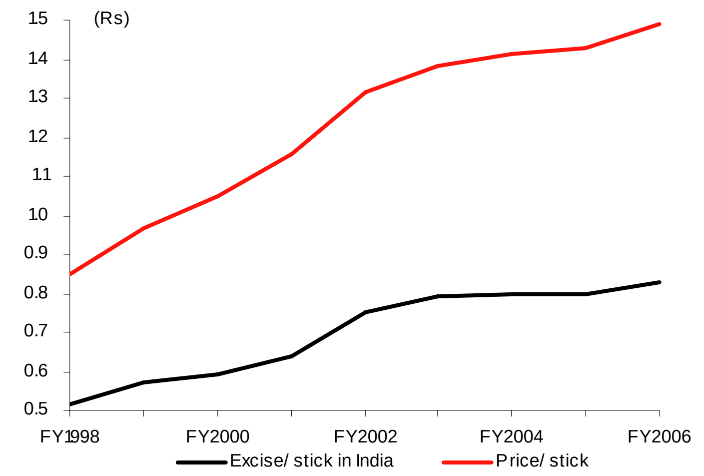
Fig 13 Taxes passed onto consumer in the US…



* Federal and state taxes (sales tax not included)

Source: US State Dept. of Agriculture, Macquarie Research, April 2007

Fig 14 …and India

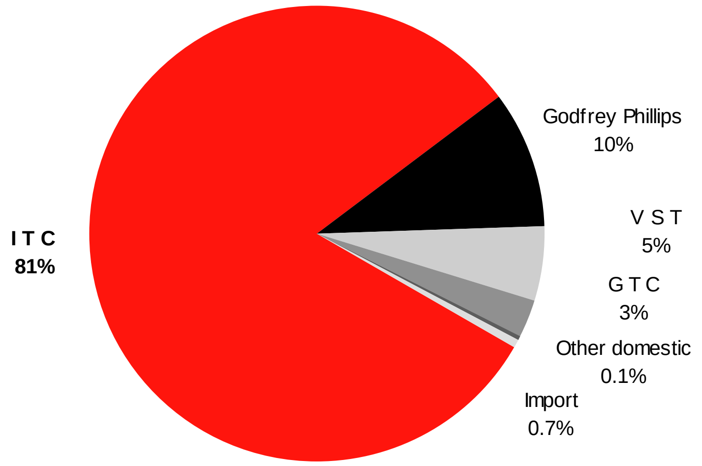


Source: ITC, Macquarie Research, April 2007

ITC is well placed to pass on the increased tax burden due to its pricing power, which arises from:

1. Virtual monopoly (>80% market share) in the US$3bn Indian cigarette market (Figure 15) with products across all price points. This is reinforced by the restriction on advertising. As in other countries, this is a major entry barrier to the Indian market for a new player or global tobacco major.

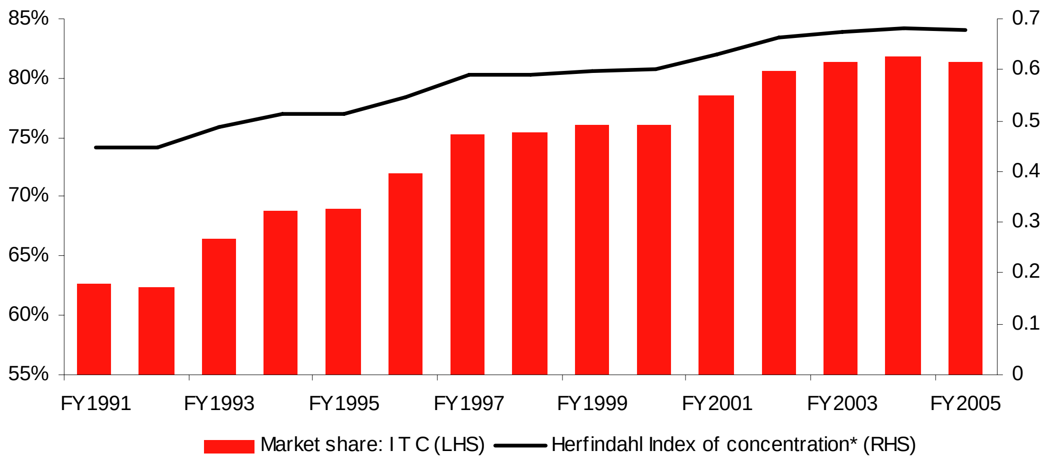
Fig 15 ITC is by far the No. 1 player in the Indian cigarette market*



* This excludes counterfeits and smuggled cigarettes, which constitute 3% of the overall market
Source: Economic Intelligence Service, Macquarie Research, April 2007

2. Importantly, ITC has steadily increased market leadership over more than 15 years. The company is the primary contributor and beneficiary of industry consolidation, which is highlighted by the rising Herfindahl index (Figure 16).

Fig 16 Pricing power – ITC has led consolidation in the industry

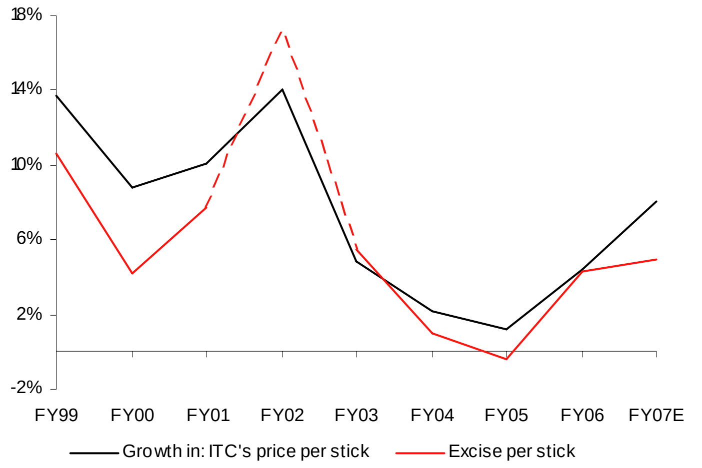


Source: Economic Intelligence Service, Macquarie Research, April 2007

** The Herfindahl index is a measure of industry competition. The index ranges from 0 to 1 with 0 signifying a large number of players and distributed market share and 1 implying a monopoly. A high Herfindahl index is generally an indicator of strong pricing power.*

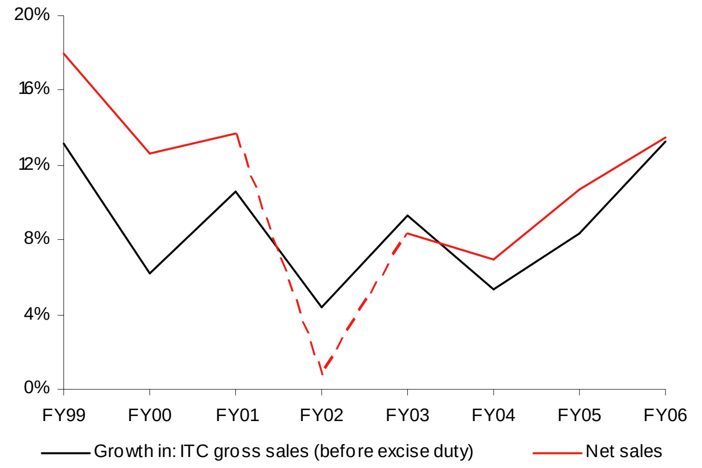
The pricing power has been used by ITC to consistently pass on tax hikes to consumers. In fact, the growth rate of ITC's cigarette realisations has consistently outpaced hikes in excise duty (Figures 17 and 18).

Fig 17 ITC – price growth has outpaced tax hikes…



Source: Company data, Macquarie Research, April 2007

Fig 18 …as shown by trends in net and gross sales

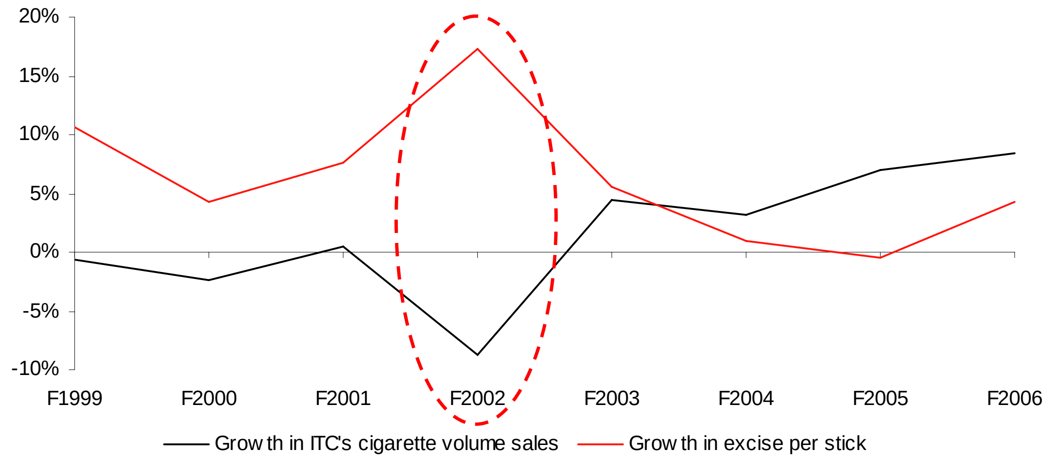


Source: Company data, Macquarie Research, April 2007

ITC's pricing power not absolute; not immune to a sharp rise in tax

ITC's pricing power is not absolute. While demand is inelastic, it is not perfectly so. This is especially true for cigarettes in the lower price segment, where there is a danger of consumers shifting to alternate cheaper products (as a result of lower taxes and refinement) such as biris and chewing tobacco or cheaper counterfeits/smuggled goods. Case in point: In 2001, the hike in excise duties incidence (for FY2002) in the union budget resulted in a 17% effective increase in excise duty on ITC's cigarette sticks. ITC could not pass on the complete burden to consumers and hiked prices such that realisations improved 14%. This obviously had an impact on cigarette volume sales, which dropped 9% as a result – the only year in this decade to see a significant volume decline (Figures 17, 18 and 19).

Fig 19 Cigarette demand inelastic but not immune to sharp changes



Source: Company data, Macquarie Research, April 2007

This leads us to believe that ITC faces a trade-off between:

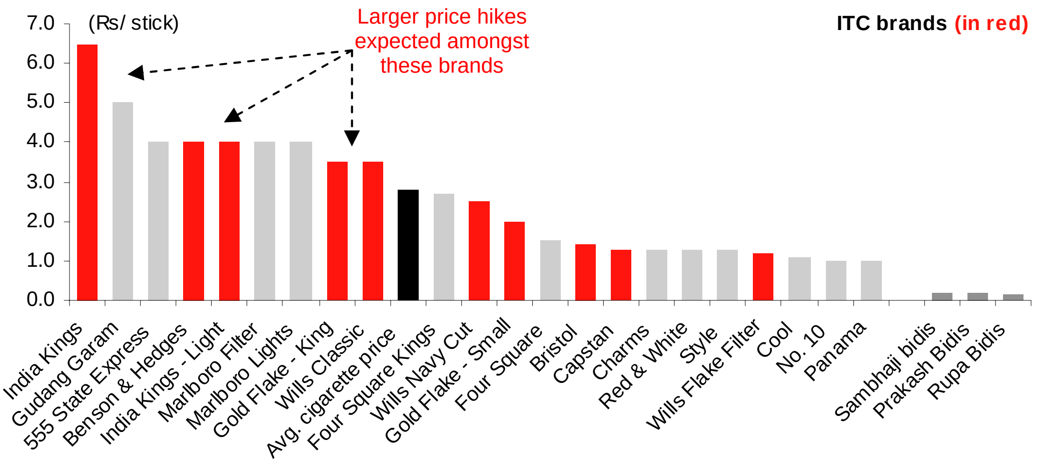
- Cigarette volumes, if prices are hiked in line with the increase in tax incidence; and
- Margins, if ITC decides to absorb some of the hit of the increased tax burden.

ITC expected to pass on tax burden over next 18-24 months

We perform a scenario analysis to ascertain the point at which ITC would maximise value from the volume-margin trade-off. We estimate that:

- ITC is likely to pass on the tax burden (from 5% hike in excise duty and implementation of 12.5% VAT) only partially in FY08. The complete impact will be passed on through price hikes over the following 18–24 months.
- We expect to see price hikes will come in two (or three) phases. ITC has cigarette brands at multiple price points (Figure 20). The lower price products are more likely to lose share to cheaper cigarette substitutes (such as 'biris' and chewing tobacco, which enjoys a lower tax). ITC is therefore likely to concentrate its price hikes on the more inelastic, higher-priced brands (eg, Benson & Hedges, Gold Flake and Wills) to cross-subsidise lower or no price hikes in lower-priced brands (eg, Bristol, Capstan).
- We expect the first phase of price hikes, ie, 5–10% for ITC's higher-priced brands, to come through in the next two months.

Fig 20 ITC's products across price points

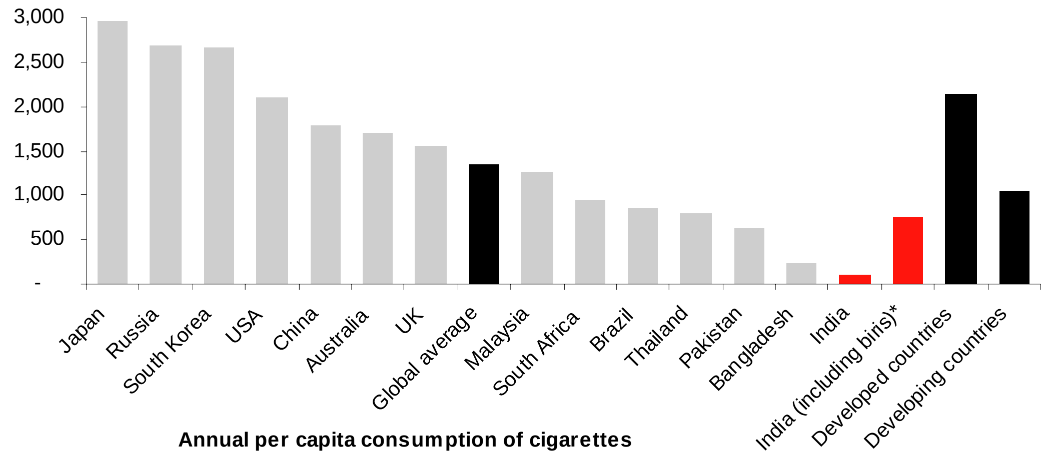


Source: Industry sources, Economic Intelligence Service, Macquarie Research, April 2007

Ample growth potential due to limited per-capita cigarette consumption

Per-capita cigarette consumption in India is still amongst the lowest globally (Figure 21). In fact, it is around a tenth of the average for developing nations and less than half that for other emerging countries such as Bangladesh, Pakistan and Thailand. Cigarettes contribute only 15% of overall tobacco consumption in India (with lower-cost products such as 'biris' and chewing tobacco contributing the rest). However, even after adjusting for this, we note that the per-capita consumption is still ~30% below the average for developing nations. There thus appears to be an opportunity, given the presence of a large base of tobacco consumers, who would upgrade to cigarettes with rising income levels.

Fig 21 India's per capita cigarette consumption – solid upside potential



* Cigarettes contribute only 15% of tobacco consumption

Unit: Number of cigarettes consumed annually

Source: Macquarie Research, April 2007

In our opinion, this leaves ample growth opportunity for ITC to exploit. We are confident that ITC will tide over the pain of weak FY08E volumes and return to a normalised profit CAGR of 18% for the cigarettes business and 20% for the entire company (Figure 22).

Fig 22 Snapshot of key operating parameters for cigarettes business

Year-end March	FY05	FY06	FY07E	FY08E	FY09E	FY10E
Sales volume (m sticks)	69,998	75,894	81,207	79,582	85,949	91,965
-growth	7.1%	8.4%	7.0%	-2.0%	8.0%	7.0%
Price ('000 sticks)	1,428	1,492	1,567	1,786	1,857	1,969
-growth	1.2%	4.5%	5.0%	14.0%	4.0%	6.0%
Segment revenue (Rs m)	103,250	116,447	130,564	145,613	163,265	184,827
Contribution to total revenue	74%	69%	67%	65%	64%	63%
Excise duty and VAT (Rs m)	56,420	62,957	70,732	90,549	101,704	114,509
Excise per stick (Rs)	0.81	0.83	0.87	0.91	0.95	0.99
-growth in excise duty per stick	-0.8%	2.9%	5.0%	5.0%	4.0%	4.0%
-VAT rate	0.0%	0.0%	0.0%	12.5%	12.5%	13.0%
EBIT (Rs m)	23,346	27,611	31,604	25,367	28,809	34,960
Contribution to EBIT	86%	83%	81%	68%	67%	68%

Source: Company data, Macquarie Research, April 2007

Scenario analysis – market is pricing in the worst-case scenario

Our scenario analysis tries to value ITC taking into account multiple variables, such as future regulation and ITC's strategy, which could significantly impact ITC's value. Our analysis shows that the market is currently pricing in a scenario whereby ITC would be able to pass the full impact of the VAT onto consumers only over 3–4 years (Figure 23).

Fig 23 Scenario analysis – market pricing in an over-pessimistic scenario

Scenario	Best case	Optimistic case	Most likely	Worst case
Regulation	Implementation of VAT with no roll-back of central excise/ AED**	Implementation of VAT with tax incentives* or limited excise hike in FY09E	Implementation of VAT with no roll-back of central excise/ AED**	Implementation of VAT with no roll-back of central excise/ AED**
ITC's strategy	ITC to increase prices broadly in line with tax increase but volumes prove resilient	ITC to increase prices broadly in line with tax increase	ITC to pass VAT burden onto consumers partially with small impact on volumes	ITC to pass VAT impact onto consumers over 3–4 years
Cigarette volume growth (FY08E)	4.0%	2.0%	**-2.0%**	2.0%
Cigarette volume growth (FY09E)	8.0%	8.0%	**8.0%**	7.0%
Price growth (FY08E)	14.0%	12.0%	**14.0%**	7.0%
Price growth (FY09E)	5.0%	4.0%	**4.0%**	5.0%
Hike in excise duty (FY08E)	5.0%	2.0%	**5.0%**	5.0%
VAT rate (FY08E)	12.5%	12.5%	**12.5%**	12.5%
DCF based value (Rs/ share)	205	200	**195**	155
Upside from current price	32%	29%	**26%**	0%
Probability of occurrence	5%	25%	**65%**	5%

* Could involve other tax benefits or implementation of VAT on price (ex-tax)

** Additional excise duty

Source: Macquarie Research, April 2007

We believe this is too pessimistic. ITC's experience in FY2002 shows that the company was able to pass on the full impact of the 17% hike in excise duty over 18–24 months (Figures 17 and 18). We forecast a repeat performance in FY08 and price hikes to catch up with VAT over 18–24 months. In fact, we expect the first phase of price hikes, ie, 5–10% for ITC's higher-priced brands, to come through in the next two months.

Cigarette volumes more resilient than in FY2002

We expect a 14% hike in prices by ITC in FY08E to partially pass on the 12.5% VAT imposed on cigarettes. We note that this is similar to the price hike in FY2002 in response to a 17% effective hike in excise duty. However, we believe that the market is currently in a better position to absorb the price hikes than it was in FY2002. This is due to the increased income levels and penetration/share of higher-priced cigarettes. We therefore believe that the decline in cigarette volumes this time will be moderate (2% decline) compared to the 9% decline seen in FY2002.

This should help ITC tide over weak volumes in FY08E and return to a normalised profit CAGR of 20%. We value ITC based on the available growth potential in cigarettes and other ventures such as FMCG, hotels, paper and agribusiness. *(Our DCF based value of Rs195 is discussed in detail earlier in this report)*.

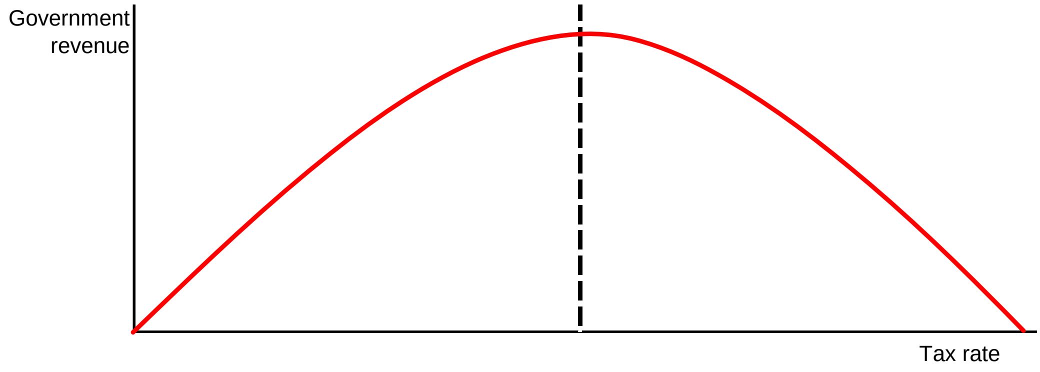
Is there a risk of a sharp tax hike in FY09?

We think not! Cigarettes are an important source of revenue for the government

We forecast FY08 volumes to fall 2% YoY as a result of the implementation of VAT and a 14% cigarette price hike by ITC. We note that in 2002, a hike in 17% excise duty incidence for ITC prompted a 14% hike in prices (Figures 17, 18 and 19). This led to a 9% decline in volumes. We note that excise duty on cigarettes is a huge source of revenue for the central government as it contributes 85% of tobacco revenue and 2–3% of total tax revenue.

While cigarette demand is relatively inelastic, the 'Laffer curve' (Figure 24) clearly shows that excessive taxation will impact tax collection.

Fig 24 Laffer curve – tax revenues diminish on excessive taxation



Source: World Bank, Macquarie Research, April 2007

This gives us confidence that, as in 2003, the possibility of another sharp hike in taxation (by the central or state governments) remains remote in the near term. This is because the government may not want to negatively impact cigarette-related tax collections.

Possibility of additional 5% upside

As a result, there is a distinct possibility that the hike in excise duty on cigarettes in FY09E will be limited. We also do not rule out the possibility of tax incentives (such as a partial roll-back of excise) to offset the impact of VAT.

We have not included this in our estimates, but we note that in such case, there would be further 5% upside potential for ITC shareholders from the current market price (Figure 23).

Return on investments to reduce exposure to cigarettes

Cashflows from cigarettes invested in growth opportunities

The cigarette business by nature provides strong cashflows. This has allowed ITC to invest substantially over the last five years: US$550m (~75% of total capex) in hotels, paper, FMCG and agribusinesses: Note that these are either long gestation-high return (eg, hotels) or ITC has found a natural synergy with its widespread cigarette distribution network (eg, FMCG – confectionary).

- ***FMCG – Others***: ITC entered into the branded and packaged foods business in August 2001. The foods business today comes under four categories in the market: Ready to eat foods, Staples, Confectionary and Snack foods. The products are sold under five well-known brands: Kitchens of India, Aashirvaad, Sunfeast, Mint-O and Candyman. This segment also includes stationery products that are sold under two brands: Paper Kraft and Classmate. In addition, ITC markets products like safety matches, or '*agarbattis*' (incense sticks) that are sourced from the small sector.
- We expect this business to turn profitable in FY10E (Figure 25).
- ITC's has also recently announced plans to tap the 30% pa growth of the Indian organised snacks retail market. It plans to offer potato chips and finger snacks under the brand Bingo, directly targeting the market currently dominated by PepsiCo's Frito-Lay. We believe this venture will derive significant synergies from ITC's strong cigarette distribution network. The backward linkages that ITC has established with farmers through 'e-choupal' should help drive procurement efficiency.

Fig 25 Snapshot of key operating parameters for other (non-cigarette) FMCG business

Year-end March	FY05	FY06	FY07E	FY08E	FY09E	FY10E
Branded package foods (Staples, biscuits & confectionery) (tonne)	207,547	344,305	482,027	602,534	753,167	941,459
-growth	148.7%	65.9%	40.0%	25.0%	25.0%	25.0%
Branded package foods sales (Rs m)	3,572	6,536	9,608	12,610	16,551	21,723
-growth	161.7%	83.0%	47.0%	31.3%	31.3%	31.3%
Other (Branded garments, card, Ready to eat foods) (Rs m)	2,331	3,913	5,086	6,612	8,596	10,315
-growth	0.0%	67.9%	30.0%	30.0%	30.0%	20.0%
Segment revenue (Rs m)	5,626	10,889	14,673	19,195	25,111	31,993
Contribution to total revenue	4%	6%	8%	9%	10%	11%
EBIT (Rs m)	-1,952	-1,730	-1,378	-630	-275	301
Contribution to EBIT	-7%	-5%	-4%	-2%	-1%	1%

Source: Company data, Macquarie Research, April 2007

- ***Hotels*:** ITC-Welcomgroup comprises over 65 hotels across more than 50 destinations in India. These include super deluxe and five-star hotels, heritage palaces, '*havelis*' and resorts, and full-service budget hotels. Currently, 10 of the ITC-Welcomgroup hotels are marketed worldwide by Starwood Hotels & Resorts, the well-known global hospitality chain.
- Tourist arrivals are driving robust demand for hotel rooms, while supply has not been able to keep pace with such growth. We believe that the supply-demand mismatch is the primary reason for the strong growth of premium hotels even in the lean season. This is potentially a strong growth and margin opportunity for ITC (see Appendix 1: International tourists can't get enough of India, for a discussion on the potential of the Indian hotels industry).
- As a result, it is our view that hotels will prove to be the fastest-growing business for ITC with 26% revenue CAGR and 31% EBIT CAGR over the next five years (Figure 26).

Fig 26 Snapshot of key operating parameters for hotels business

Year-end March	FY05	FY06	FY07E	FY08E	FY09E	FY10E
Number of rooms	4,900	4,900	5,635	6,086	6,390	7,157
-growth	6.5%	0.0%	15.0%	8.0%	5.0%	12.0%
Average room rate (Rs/ day)	4,948	6,594	7,583	8,721	10,029	10,831
-growth	20.7%	33.3%	15.0%	15.0%	15.0%	8.0%
Occupancy rate (%)	70	71	75	90	90	80
Revpar (Rs/ day)	3,488	4,708	5,687	7,849	9,026	8,665
-growth	31.3%	35.0%	20.8%	38.0%	15.0%	-4.0%
Segment revenue (Rs m)	6,233	8,407	11,573	17,248	20,827	22,393
Contribution to total revenue	4%	5%	6%	8%	8%	8%
EBIT (Rs m)	1,597	2,872	4,182	6,787	8,432	9,147
Contribution to EBIT	6%	9%	11%	18%	20%	18%

Source: Company data, Macquarie Research, April 2007

- ***Agribusiness*:** ITC's International Business Division focuses on segments like feed ingredients, food grains, edible nuts, marine products and processed fruits. The strength of this business is the extensive backward linkages it has established with the farmers through e-choupal (see Appendix 2: ITC e-choupal: Re-engineering rural growth, for a discussion on e-choupals). ITC has been a significant exporter of seafood from India since 1971. Some of its well-known brands are Gold Ribbon, Blue Ribbon and Aqua King. The e-choupal system gives ITC access to market its products to 60% of India's population (rural population involved in agriculture), which is currently almost untapped by marketing companies and which could prove to be the engine of long-term growth.
- The agribusiness provides an excellent sourcing base for the FMCG (non-cigarettes) business. Additionally, we forecast segment EBIT (as a result of external sales) to grow at 28% CAGR over the next five years (Figure 27).

Fig 27 Snapshot of key operating parameters for agribusiness

Year-end March	FY05	FY06	FY07E	FY08E	FY09E	FY10E
Segment revenue (Rs m)	11,935	19,275	22,185	25,423	29,235	33,179
Contribution to total revenue	9%	11%	11%	11%	11%	11%
EBIT (Rs m)	964	909	1,147	1,506	2,194	2,511
Contribution to EBIT	4%	3%	3%	4%	5%	5%

Source: Company data, Macquarie Research, April 2007

- ***Paperboards, paper and packaging*:** The amalgamation of the erstwhile ITC Bhadrachalam Paperboards with itself has allowed ITC to go into the manufacture of paperboards and speciality papers such as cast coated boards, liquid packaging board and recycled boards. The product offerings of ITC's packaging & printing business ranges from flip top boxes and display outers to shells and slides and inner frames. In addition, ITC occupies a leadership position in cigarette and liquor packaging in India. It supplies packaging to cover 70bn cigarettes a year domestically, and supplies packaging for 15bn cigarette sticks a year for the export market.
- Capacity addition, which will come on-stream in FY09E and FY10E, is likely to drive 8% revenue CAGR and 4% EBIT CAGR over the next five years. EBIT growth will resume at 8–10% CAGR once operational efficiencies at the expanded capacity begin to kick in and offset the impact of depreciation on the new facilities (Figure 28).

Fig 28 Snapshot of key operating parameters for paperboards, paper and packaging business

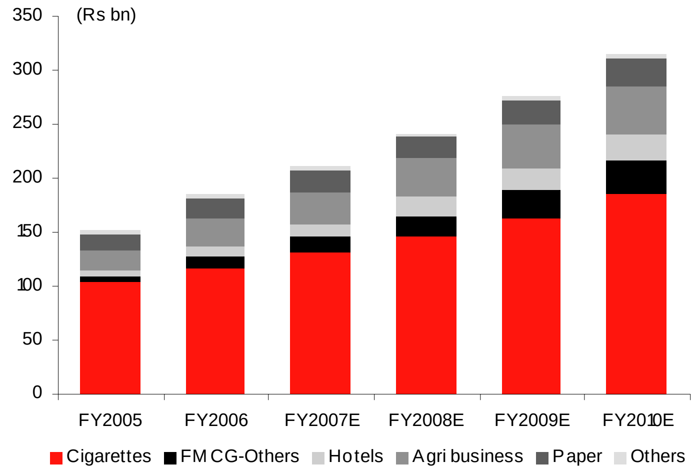
Year-end March	FY05	FY06	FY07E	FY08E	FY09E	FY10E
Capacity (tonne)	352,500	352,500	352,500	352,500	452,500	532,500
Paper volume (tonne)	256,920	309,926	317,250	334,875	362,000	426,000
-growth	37.5%	20.6%	2.4%	5.6%	8.1%	17.7%
Cost per tonne (Rs)	35,065	34,553	34,553	34,553	34,553	34,553
-growth	-2.7%	-1.5%	0.0%	0.0%	0.0%	0.0%
Segment revenue (Rs m)	9,738	11,260	11,526	12,166	13,152	15,477
Contribution to total revenue	7%	7%	6%	5%	5%	5%
EBIT (Rs m)	2,800	3,514	3,574	3,880	3,738	3,941
Contribution to EBIT	10%	11%	9%	10%	9%	8%

Source: Company data, Macquarie Research, April 2007

Investments beginning to bear fruit

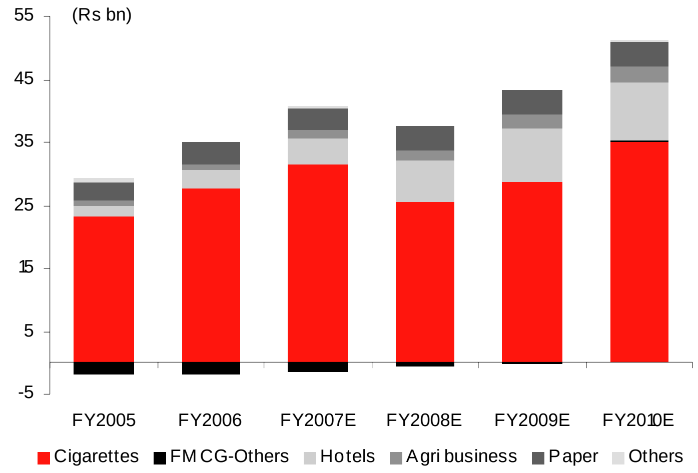
Cigarettes remain the major profit contributor of ITC; however, their influence is clearly diminishing (due to the ramp-up of other businesses, as mentioned in previous sections). Cigarettes' contribution to revenues has decline from ~80% in FY03 to 69% in FY06 (Figure 29). Investments made in the long-gestation, fast-growing hotels, paper and agribusiness ventures are starting to show returns and have a material earnings impact. In fact, the contribution of cigarettes to EBIT has fallen from 90% to ~80% over the last three years. We forecast that this will continue falling to ~66% over the next five years (Figure 30), driven by the projected 31% EBIT CAGR for the non-cigarette businesses. This should help provide resilience and impetus to the bottom line.

Fig 29 Impact of non-cigarette revenue streams



Source: Company data, Macquarie Research, April 2007

Fig 30 EBIT – cigarettes continue to dominate



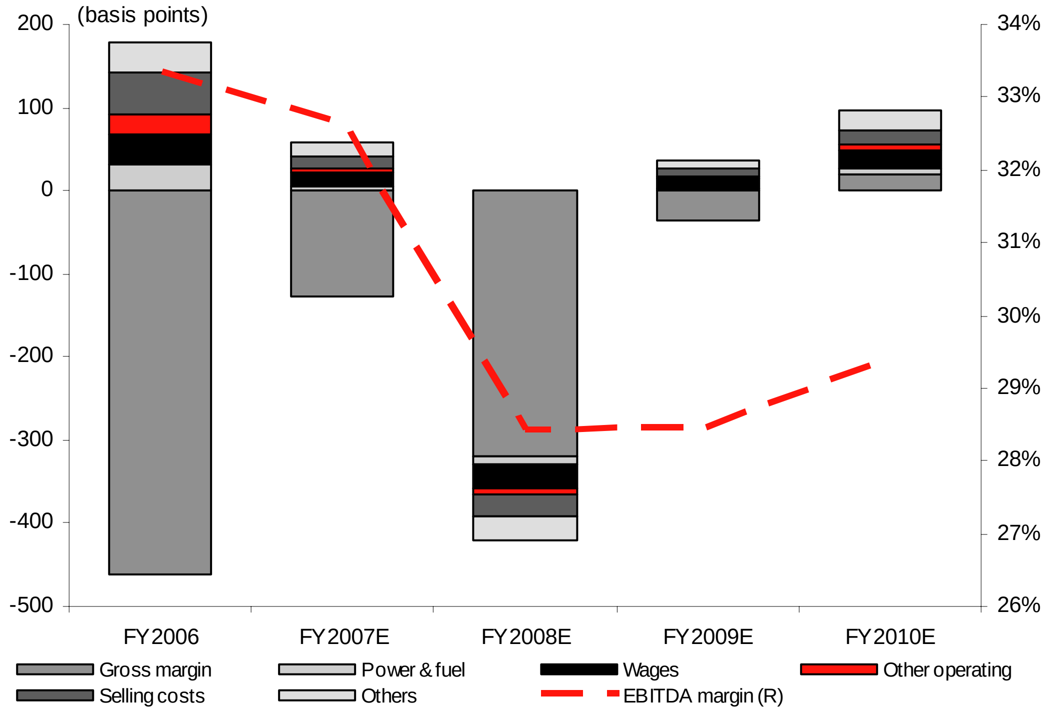
Source: Company data, Macquarie Research, April 2007

Expect 20% earnings CAGR from FY09E

The cumulative impact on margins is shown in Figure 31. We believe that the implementation of VAT will have a sharp negative impact on margins in FY08E. However, margins should thereafter recover from the low FY08E base and rise consistently from FY09E onwards, driven by the following factors.

- ITC cigarettes will take a margin hit in FY08E. However, cigarette prices have outpaced tax hikes consistently in the last decade. We expect this trend to resume from FY09E. We expect margin pressure from further tax hikes to be more than compensated by hikes in prices and sourcing efficiencies.
- Robust demand for hotel rooms, due to strength in the economy and supply constraints.
- FMCG (non-cigarette) losses expected to reduce till the business finally turns profitable in FY10E.
- Margin improvement in agribusiness due to scale and improvements in infrastructure.

Fig 31 Drivers of change in EBITDA margin



Source: Company data, Macquarie Research, April 2007

These factors are likely to drive overall earnings CAGR to 20% from FY09E. As consensus downgrades earnings estimates by factoring in the impact of VAT, we expect to stand 5% above consensus for FY09E.

Limited exposure to key headwinds

Strong defensive play against 3 key risks faced by Indian markets

The Indian market indices are currently exposed to three prominent risks, which make investors nervous.

⇒ A slowdown in the US economy.

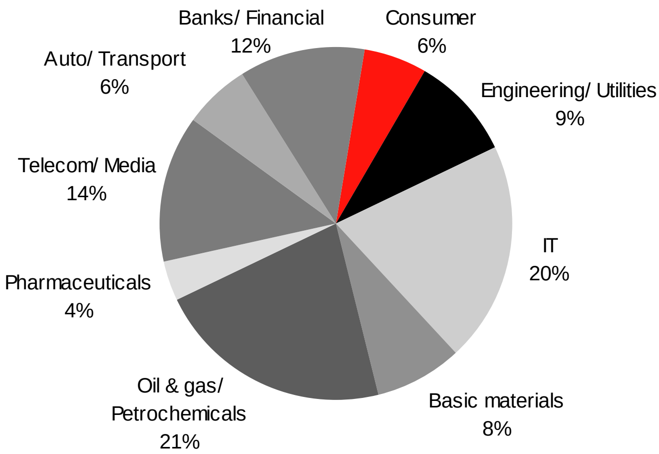
⇒ Rising interest rates.

⇒ Softening of commodity prices/

The Indian market is dominated by players exposed to these three risks in one or more ways. In fact, such stocks comprise 77% of the index market cap (Figure 32).

We note that ITC's operations have minimal exposure to these risks, making ITC a strong defensive play against these factors.

Fig 32 ITC – amongst the least exposed to the three key risks faced by the market



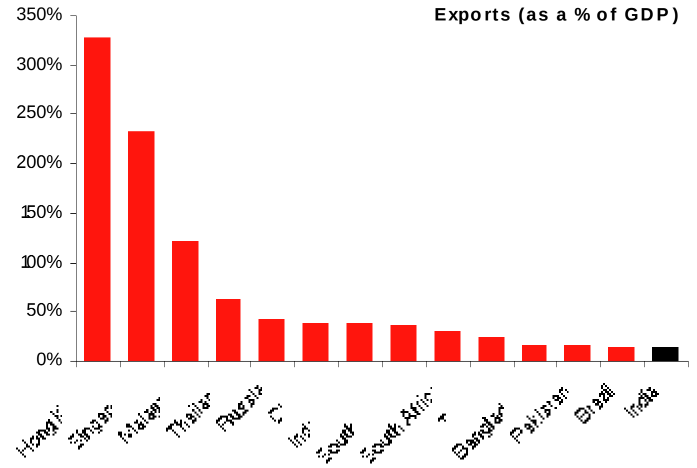
Source: Bloomberg, Macquarie Research, April 2007

Direct play on the imminent 'great Indian consumption boom'

India's GDP has been growing at a scorching pace. The country has averaged an annual growth rate of >8% for the past three years. While this has been a pleasant surprise, we believe the best is yet to come! The recent upgrade of India's GDP growth rate by our regional economist, Bill Belchere, confirms our view.

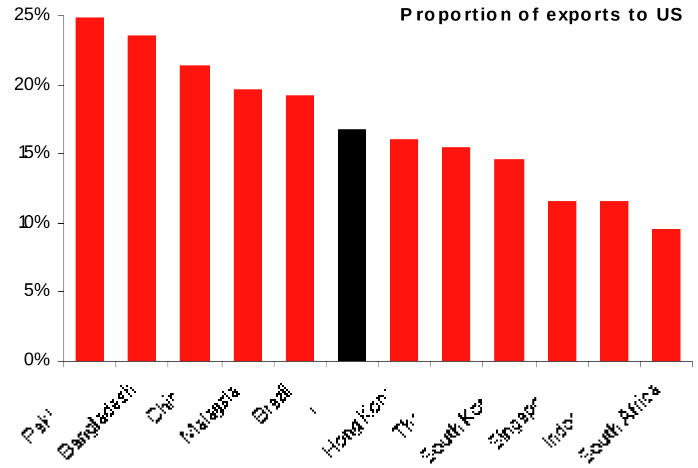
- Bill forecasts that India's GDP will grow at 9.0% in FY07 and average 8–8.5% in the medium term. This is despite forecasts of a relative US and global slowdown, since India's exposure to the US and the global economy remains low (Figures 33 and 34).

Fig 33 India – strong domestic demand-driven story



Source: CIA, Macquarie Research, April 2007

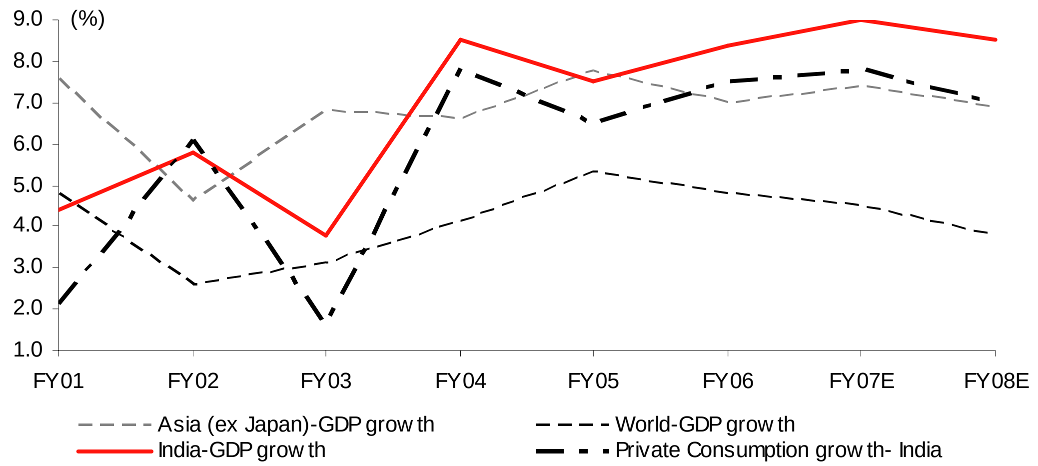
Fig 34 Low exposure to the US economy



Source: CIA, Macquarie Research, April 2007

- Growth in real consumer spending is expected to average 7% pa on a sustained basis – much faster than at any other time in the past.

Fig 35 Macquarie's GDP and private consumption growth rate forecasts



Source: Macquarie Research, April 2007

- GDP per capita is estimated at ~US$700 (at current prices). A stable rupee and 8% GDP growth would put India over the US$1,000 per-capita threshold by FY10E.

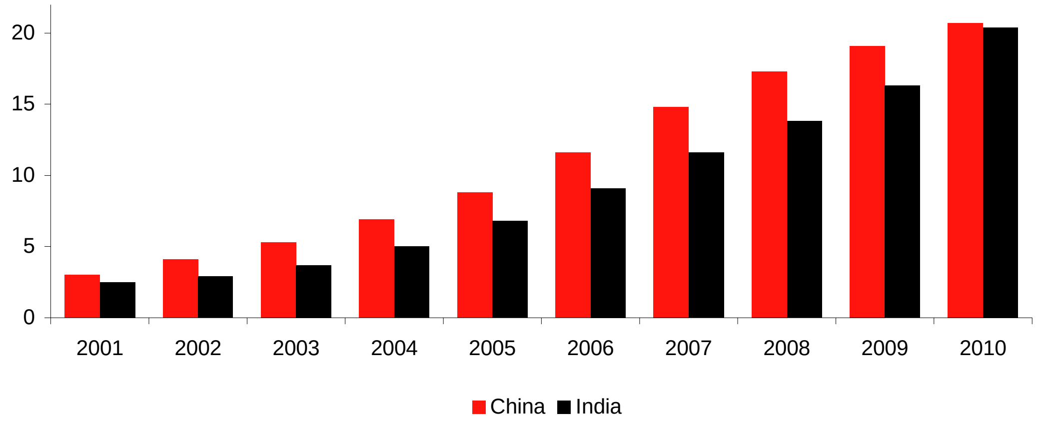
We believe that key demographic shifts and changes in the macro-environment are poised to drive a consumption boom in India.

Key demand drivers

1) Rapidly rising disposable incomes

With a strong economy, real annual personal disposable incomes are set to increase by 8-10% annually over 2006–10. Median household incomes are expected to grow from US$2,000 in 2005 to US$3,200 by 2010. Economists Intelligence Unit data (Figure 36) shows how households that earn >US$5,000 are expected to grow over the next four years.

Fig 36 Proportion (%) of households earning more than US$5,000 pa



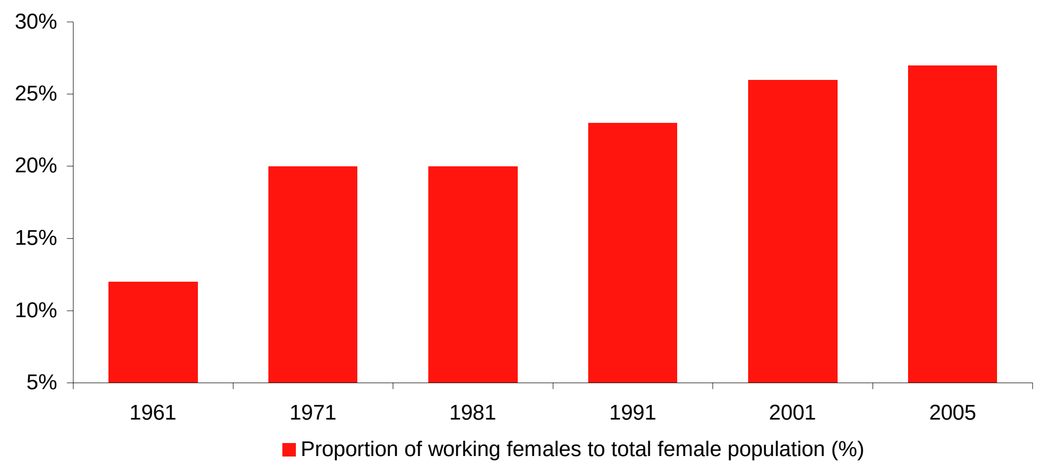
Source: Economists Intelligence Unit, August 2006

We note that the Indian consumption boom story is not just limited to luxury goods, as a result of a larger number of people entering the affluent class. A sea of people is entering the middle class, allowing cabdrivers to carry mobile phones and parking attendants to wear jeans, for example. This 'inclusive' growth is a positive for ITC, whose target market spans the entire spectrum of income levels, geographies and urban-rural divide, and is not just concentrated in the upper-income group.

2) Increasing proportion of working women

This rising consumption trend is also on account of changing social patterns. The increasing proportion of working women (Figure 37) is leading to a higher number of dual-income families. This obviously results in higher disposable income available for households, translating into higher expenditure and a better standard of living.

Fig 37 Higher proportion of working women adding to disposable income

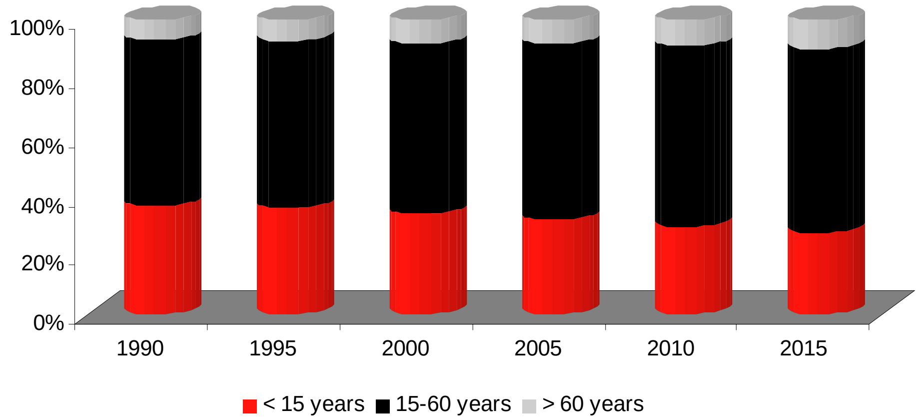


Source: Census data, CRIS-INFAC, Macquarie Research, April 2007

3) Changing demographics

India's 'young' population demographics and reducing 'dependency ratio' should also help spur consumption growth.

Fig 38 India's population – growing younger as time passes

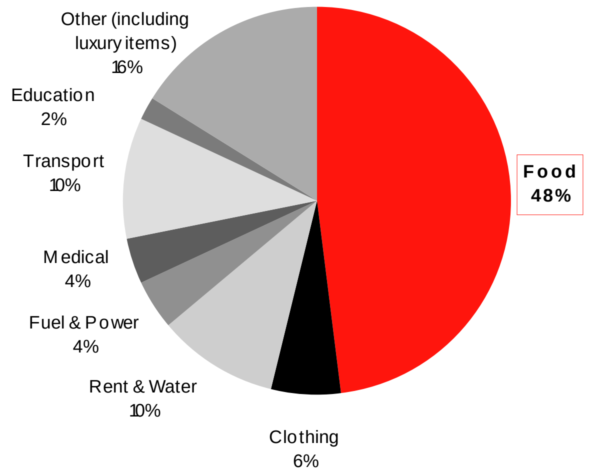


Source: Census 2001, CRIS INFAC, Macquarie Research, April 2007

4) Consumption of leisure has grown at a faster pace

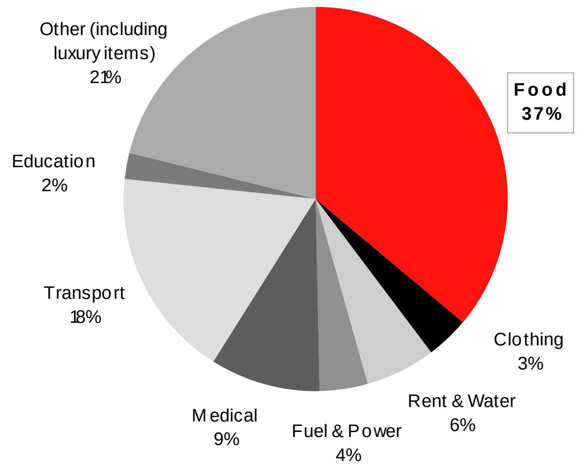
Consumption patterns are changing (Figures 39 and 40). Food expenditure as a percentage of total consumption has dropped from ~50% in FY91 to less than 40% currently (39% in FY04). While the entire pie is expected to grow at 7–7.5% over the medium term, we expect food's share in the consumption basket to continue to fall.

Fig 39 India's consumption mix, FY91



Source: Macquarie Research, April 2007

Fig 40 India's consumption mix, FY08E



Source: Macquarie Research, April 2007

Overall, India seems set to witness a consumption boom, driven by key macro-economic trends, demographic and social changes, and emerging attitudes.

We believe ITC, a key consumer sector play, is set to benefit due to two emerging trends.

- Increased consumption of cigarettes and FMCG products due a growing middle class.
- Shift in market share in favour of cigarettes (vs cheaper tobacco products such as bidis) due to an increase in income levels and discretionary spend.

Well placed to benefit from improving supply chain/logistics

ITC has nearly 2m outlets for distribution of cigarettes and FMCG products. Notably, these outlets are serviced at an average frequency of every three days and the network reaches villages with populations as low as 2,000. On the procurement side, ITC's e-choupal system sources raw material and fresh produce for its FMCG, retail and agribusinesses directly from >3.5m farmers through 6,500 kiosks across 38,000 villages in India.

The government's focus and spend on infrastructure makes us believe that ITC will be a key beneficiary of improving supply chain/logistics efficiencies.

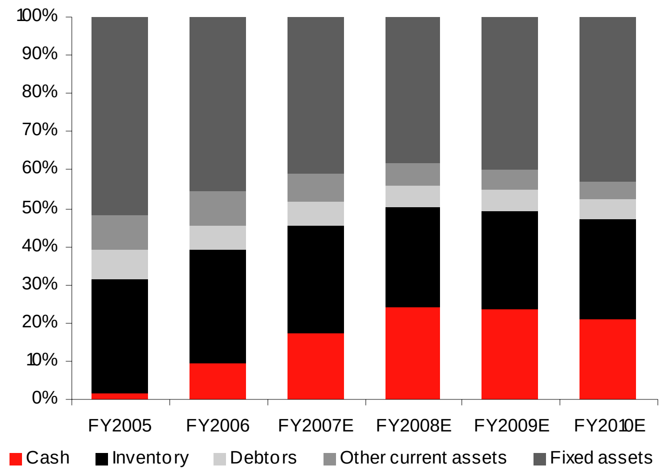
Sweet spot in free cashflow

Solid balance sheet and cashflow position

As mentioned earlier, cigarettes are by nature a highly cash-rich business. Despite significant investments into long-gestation-period businesses during the past decade, the company is in a strong net cash position (Figure 41).

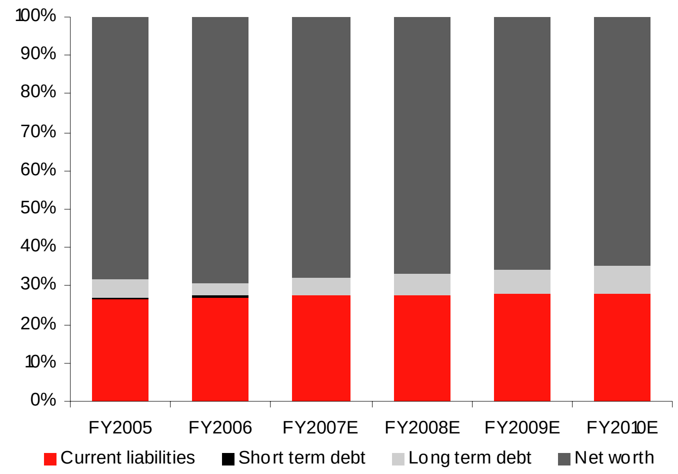
We believe the past trends will continue. The cash currently on the balance sheet and expected cashflow from operations should be sufficient to meet the planned capex requirements and maintain the dividend payout ratio above 40%. Based on currently announced plans, ITC does not need to raise any debt in the next five years (Figures 41 and 42).

Fig 41 Assets – cash position strong and rising



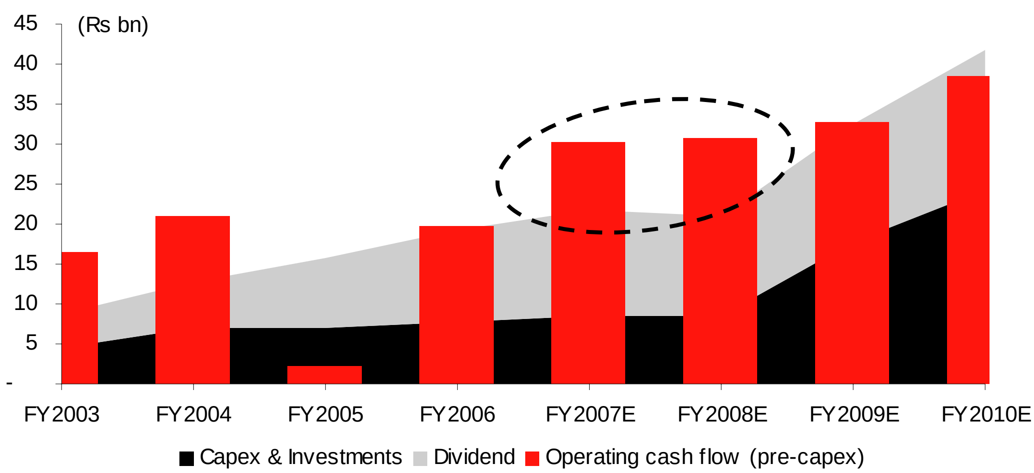
Source: Company data, Macquarie Research, April 2007

Fig 42 Debt-free balance sheet enhances flexibility



Source: Company data, Macquarie Research, April 2007

Fig 43 US$400m of unutilised cash on the table



Source: Company data, Macquarie Research, April 2007

Strong free cashflow position raises possibility of an event

We estimate that ITC will have US$400m of unutilised cash over the next two years (Figure 43) after accounting for planned capex and (normal) dividends. Based on the company's history, we rule out the possibility of special dividends and buybacks. Fundamentally, we like the idea of using this war chest for investments in the FMCG space. The experience from hotel and paper ventures tells us that this could yield 20% RoCE over 3–5 years.

An example of this could be ITC's decision to tap the 30% growth of the Indian organised snacks retail market by launching potato chips and finger snacks under the Bingo brand.

ITC Ltd (ITC IN, Outperform, Target price: Rs195.00)

Profit & Loss		2002A	2003A	2004A	2005A
Revenue	**m**	52,101	61,613	67,984	79,912
Gross Profit	**m**	31,967	35,899	43,891	51,154
Cost of Goods Sold	m	20,134	25,714	24,093	28,759
EBITDA	**m**	18,884	22,144	24,491	28,899
Depreciation	m	2,160	2,598	2,730	3,366
Amortisation of Goodwill	m	0	0	0	0
Other Amortisation	m	0	0	0	0
EBIT	m	18,188	20,830	23,946	27,775
Net Interest Income	m	-782	-417	-340	-501
Associates	m	0	0	0	0
Exceptionals	m	0	0	0	0
Forex Gains / Losses	m	0	0	0	0
Other Pre-Tax Income	m	431	787	269	25,106
Pre-Tax Profit	m	17,406	20,413	23,607	27,274
Tax Expense	m	-6,035	-7,201	-7,536	-9,544
Net Profit	m	11,617	13,730	16,160	22,454
Minority Interests	m	-10	-48	-179	-156
Reported Earnings	**m**	11,617	13,730	16,160	22,454
Adjusted Earnings	**m**	11,362	13,165	15,891	17,574

Profit & Loss		2006A	2007E	2008E	2009E
Revenue	**m**	102,871	120,760	129,767	150,567
Gross Profit	**m**	61,106	70,193	71,281	82,170
Cost of Goods Sold	m	41,765	50,567	58,486	68,397
EBITDA	**m**	34,292	39,410	36,888	42,813
Depreciation	m	3,595	3,813	4,041	4,838
Amortisation of Goodwill	m	0	0	0	0
Other Amortisation	m	0	0	0	0
EBIT	m	30,697	35,597	32,846	37,975
Net Interest Income	m	-173	-120	-103	-85
Associates	m	0	0	0	0
Exceptionals	m	46	0	0	0
Forex Gains / Losses	m	0	0	0	0
Other Pre-Tax Income	m	3,195	3,658	4,214	5,105
Pre-Tax Profit	m	33,765	39,135	36,958	42,994
Tax Expense	m	-10,626	-12,316	-11,631	-13,531
Net Profit	m	23,139	26,819	25,327	29,464
Minority Interests	m	-185	0	0	0
Reported Earnings	**m**	22,954	26,819	25,327	29,464
Adjusted Earnings	**m**	22,907	26,819	25,327	29,464
EPS (rep)		6.11	7.14	6.74	7.85
EPS (adj)		6.10	7.14	6.74	7.85
EPS Growth (adj)	%	-13.4	17.1	-5.6	16.3
PE (rep)	x	25.4	21.8	23.0	19.8
PE (adj)	x	25.5	21.8	23.0	19.8
Total DPS		3.03	3.54	3.36	3.91
Total Div Yield	%	2.0	2.3	2.2	2.5
Weighted Average Shares	m	3,755	3,755	3,755	3,755
Period End Shares	m	3,755	3,755	3,755	3,755

Profit and Loss Ratios		**2006A**	**2007E**	**2008E**	**2009E**
Revenue Growth	%	28.7	17.4	7.5	16.0
EBITDA Growth	%	18.7	14.9	-6.4	16.1
EBIT Growth	%	20.2	16.0	-7.7	15.6
Gross Profit Margin	%	59.4	58.1	54.9	54.6
EBITDA Margin	%	33.3	32.6	28.4	28.4
EBIT Margin	%	29.8	29.5	25.3	25.2
Net Profit Margin	%	22.5	22.2	19.5	19.6
Payout Ratio	%	49.7	49.6	49.9	49.9
EV/EBITDA	x	15.6	13.6	14.5	12.5
EV/EBIT	x	17.4	15.0	16.3	14.1
Balance Sheet Ratios					
ROE	%	26.7	27.1	22.6	23.4
ROA	%	24.4	24.4	19.5	19.8
ROIC	%	42.7	43.5	39.2	46.3
Net Debt/Equity	%	-39.8	-46.2	-53.0	-51.2
Interest Cover	x	177.3	296.1	320.1	446.6
Price/Book	x	6.3	5.5	4.9	4.4
Book Value per Share		24.6	28.2	31.6	35.5

Cashflow Analysis		**2006A**	**2007E**	**2008E**	**2009E**
EBITDA	**m**	34,292	39,410	36,888	42,813
Tax Paid	m	-10,626	-12,316	-11,631	-13,531
Chgs in Working Cap	m	-2,455	258	2,846	313
Net Interest Paid	m	-173	-120	-103	-85
Other	m	-1,188	2,977	2,812	3,271
Operating Cashflow	**m**	19,849	30,209	30,812	32,782
Acquisitions	m	-29	0	0	0
Capex	m	-7,735	-8,441	-8,430	-17,785
Asset Sales	m	0	0	0	0
Other	m	3,195	3,658	4,214	5,105
Investing Cashflow	**m**	-4,569	-4,783	-4,216	-12,680
Dividend (Ordinary)	m	-11,383	-13,299	-12,627	-14,690
Equity Raised	m	1,261	0	0	0
Debt Movements	m	-1,003	-200	-200	-200
Other	m	-8	142	0	0
Financing Cashflow	**m**	-11,133	-13,358	-12,827	-14,890
Net Chg in Cash/Debt	**m**	5,054	12,068	13,769	5,212

Balance Sheet		**2006A**	**2007E**	**2008E**	**2009E**
Cash	m	38,446	50,514	64,283	69,496
Receivables	m	6,482	7,610	8,177	9,488
Inventories	m	31,154	36,572	39,300	45,599
Investments	m	1,313	1,313	1,313	1,313
Fixed Assets	m	47,612	52,240	56,629	69,576
Intangibles	m	0	0	0	0
Other Assets	m	9,271	9,271	9,271	9,271
Total Assets	**m**	134,279	157,520	178,973	204,742
Payables	m	21,825	28,627	34,769	42,692
Short Term Debt	m	528	428	328	228
Long Term Debt	m	939	839	739	639
Provisions	m	13,580	13,580	13,580	13,580
Other Liabilities	m	4,382	7,359	10,171	13,442
Total Liabilities	**m**	41,253	50,833	59,586	70,581
Shareholders' Funds	m	92,350	105,869	118,569	133,344
Minority Interests	m	818	818	818	818
Other	m	-142	0	0	0
Total S/H Equity	**m**	93,026	106,687	119,387	134,161
Total Liab & S/H Funds	**m**	134,279	157,520	178,973	204,742

All figures in INR unless noted.
Source: Macquarie Research, April 2007

Appendices

Appendix 1: International tourists can't get enough of India

Includes excerpts from the initiation report on Hotel Leelaventure, Massive capacity expansion, *dated 7 February 2007 by Jal Irani and Saurabh Jain (91 22 66533046; saurabh.jain@macquarie.com)*

Supply-demand mismatch in the hotel industry

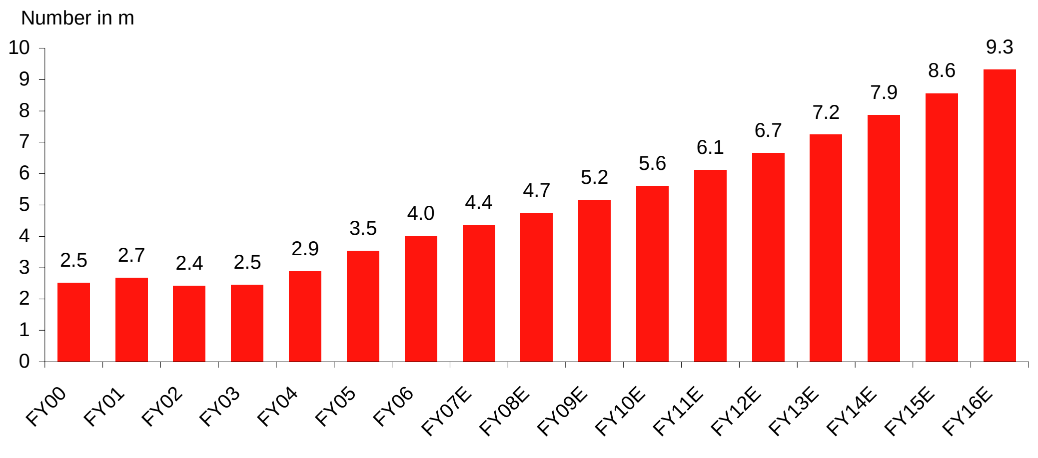
According to the Indian Department of Tourism (DoT), there were 1,892 hotels with a total of 97,770 hotel rooms in India at the end of 2004. In the five-star and five-star deluxe category, there were 167 hotels with a total of 28,867 hotel rooms, representing 29.5% of the total hotel rooms. The Ministry of Tourism estimates that there is a current shortage of 100,000 hotel rooms in India and major investment is expected in the hospitality industry to overcome this shortfall.

Average room rates (ARRs) throughout the major Indian cities (including Bangalore, Hyderabad, Chennai, Pune, Delhi) have risen more than 25% in the past two years, with occupancies at record highs. Business hotels particularly have benefited immensely due to the lack of quality rooms and the buoyant business/economic climate. Setting up a new hotel takes 2–3 years and the shortage of hotel rooms will last for at least the next 18–24 months, during which time room rates and occupancies should remain high. The new hotel rooms across most Indian cities should start coming on-stream in late 2008 and 2009, which will lower rates in cities where these are very high. Many of the properties expected to come on-stream may be delayed by about 3–6 months because of execution problems.

Tourist arrivals driving robust demand for hotel rooms….

Demand for premium hotel rooms will grow in excess of 10% in the major Indian cities over the next 4–5 years. This will come on the back of increasing international tourist arrivals (17.8% CAGR in the past three years), increasing spend per international tourist (which was US$1,490 in FY06, up 4.2% YoY) and increasing demand from domestic Indian tourists for premium hotels (on the back of high economic growth and growing consumption and lifestyle expenditure). As foreigners make up more than 50–60% of the premium hotels' clientele and ~70% of Hotel Leelaventure's clientele, it is important to consider how international tourist arrivals in India are growing. Over 4m international tourists visited India in FY06 (year-end March) and World Travel and Tourism Council (WTTC) estimates an 8.8% CAGR by FY16E.

Fig 44 International tourist arrivals in India to grow at a minimum 8.8% CAGR



Source: Cris-Infac, WTTC, Macquarie Research, April 2007

As the domestic travel and tourism industry in India grows rapidly, domestic leisure and business travellers will exert a bigger influence.

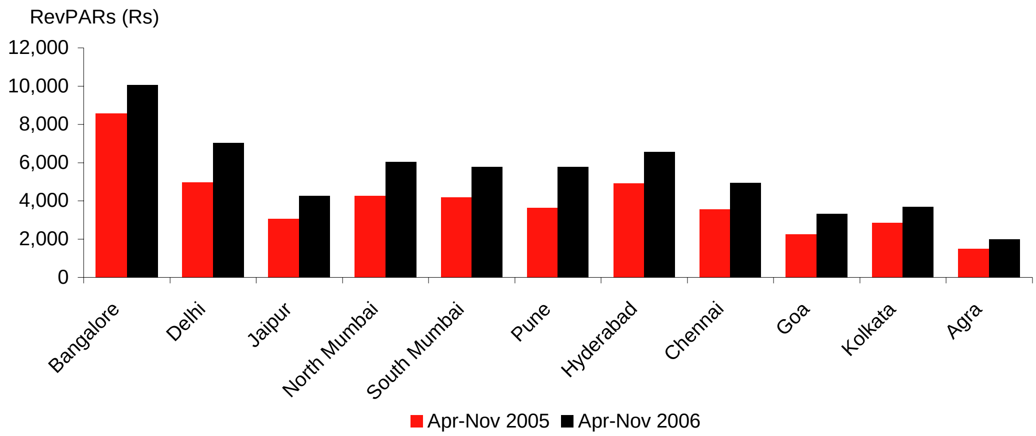
… Meanwhile, supply has not been able to keep pace with growing demand

The supply of premium hotel rooms is expected to start coming on-stream from 2008 and, depending on the city, supply growth will in most cases vary from 5–20% per year as per the schedule of properties currently planned. It would also be reasonable to expect many of the properties that are expected to come on-stream to be delayed by about 3–6 months because of execution delays. This will keep conditions favourable for the hotel industry for an extended period of time.

This has resulted in strong growth for premium hotels even in the lean season

Figure 45 shows that RevPAR for premium hotel rooms has risen throughout all cities in April-November 2006 compared with the same period last year. Even though this period has traditionally been a lean one, rates have risen due to a shortage of hotel rooms. As this shortage will continue for at least the next 18–24 months, room rates should continue to rise with occupancies remaining strong throughout the major Indian cities.

Fig 45 RevPAR for premium hotels rising even in the lean season



Source: Cris-Infac, Macquarie Research, April 2007

Figure 46 is an extension of the above chart. It shows that room rates and occupancy ratios for premium hotels are on an upward trend throughout Indian cities.

Fig 46 Premium hotels showing high growth even in the lean season

	ARRs (Rs)		Occupancy ratios (%)		RevPARs (Rs)	
City	**Apr-Nov 2005**	**Apr-Nov 2006**	**Apr-Nov 2005**	**Apr-Nov 2006**	**Apr-Nov 2005**	**Apr-Nov 2006**
Bangalore	11,173	13,371	76.7%	75.2%	8,570	10,055
Delhi	6,470	9,245	76.7%	76.2%	4,962	7,045
Jaipur	5,687	6,777	53.8%	62.7%	3,060	4,249
North Mumbai	5,482	7,713	77.6%	78.5%	4,254	6,055
South Mumbai	6,590	8,847	63.4%	65.4%	4,178	5,786
Pune	4,467	7,174	81.6%	80.4%	3,645	5,768
Hyderabad	5,819	8,515	84.6%	77.1%	4,923	6,565
Chennai	4,708	6,617	75.8%	74.9%	3,569	4,956
Goa	3,816	5,049	59.5%	65.8%	2,271	3,322
Kolkata	3,979	5,146	71.7%	71.8%	2,853	3,695
Agra	3,144	4,162	47.6%	48.0%	1,497	1,998

Source: Cris-Infac, Macquarie Research, April 2007

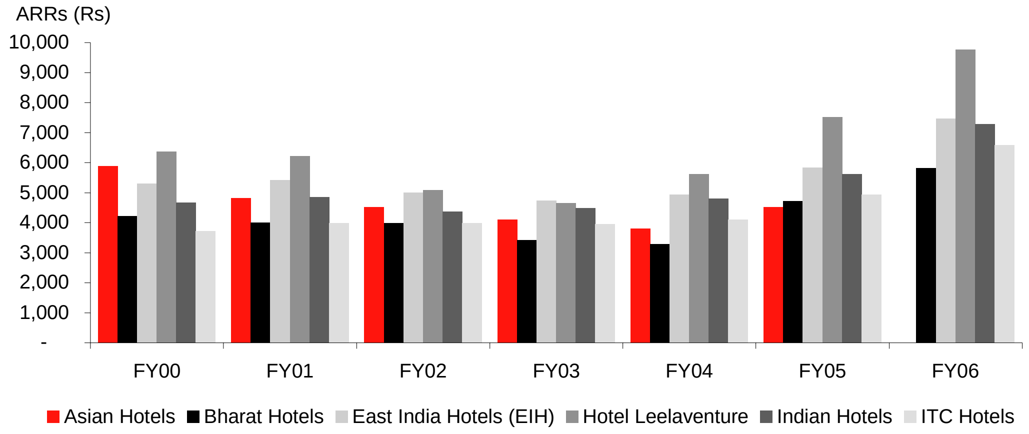
Historical performance of premium hotel chains in India

The major premium hotel chains (five-star and five-star deluxe) in India are as follows:

- Indian Hotels – The Taj group
- East India Hotels (EIH) – The Oberoi group
- ITC-Welcomgroup Hotels
- Hotel Leelaventure
- Bharat Hotels – The Grand group
- Asian Hotels – Hyatt Regency in Mumbai, Delhi and Kolkata

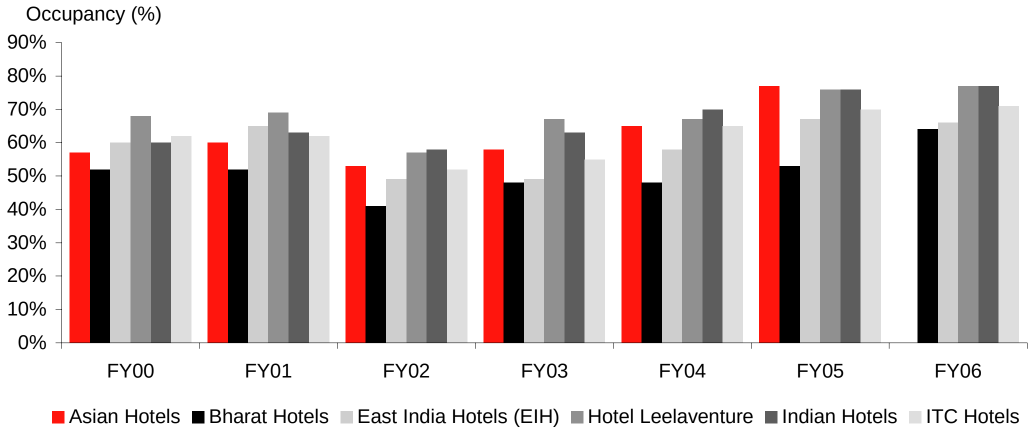
Figures 47, 48 and 49 show how ARR, occupancy ratios and RevPAR for these six premium hotel chains have performed since FY00. The ARR, occupancy ratios and RevPAR used here are the averages for the hotel chains across all their properties for that year.

Fig 47 ARRs have risen steadily since FY03



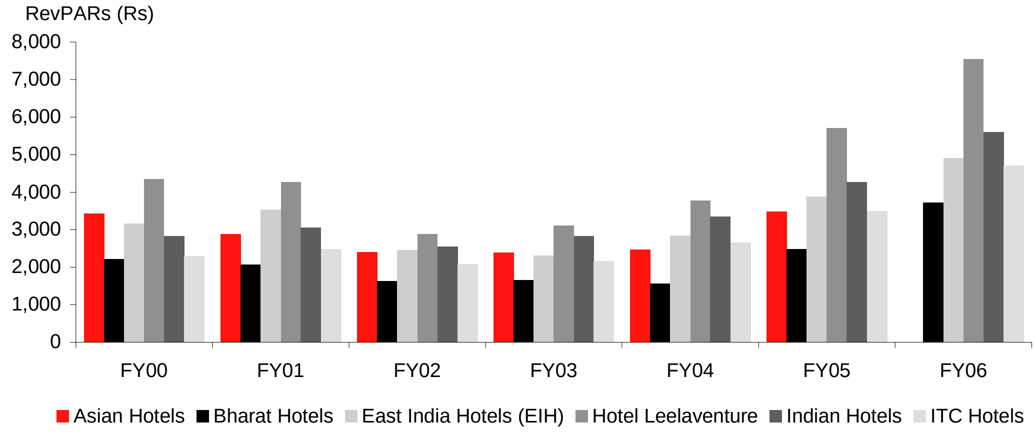
Source: Cris-Infac, Macquarie Research, April 2007

Fig 48 Occupancies at record highs in FY06



Source: Cris-Infac, Macquarie Research, April 2007

Fig 49 Consistent increase in RevPARs due to rising ARRs and occupancies



Source: Cris-Infac, Macquarie Research, April 2007

Appendix 2: ITC e-choupal: Re-engineering rural growth

Source: World Resources Institutes

About e-choupal

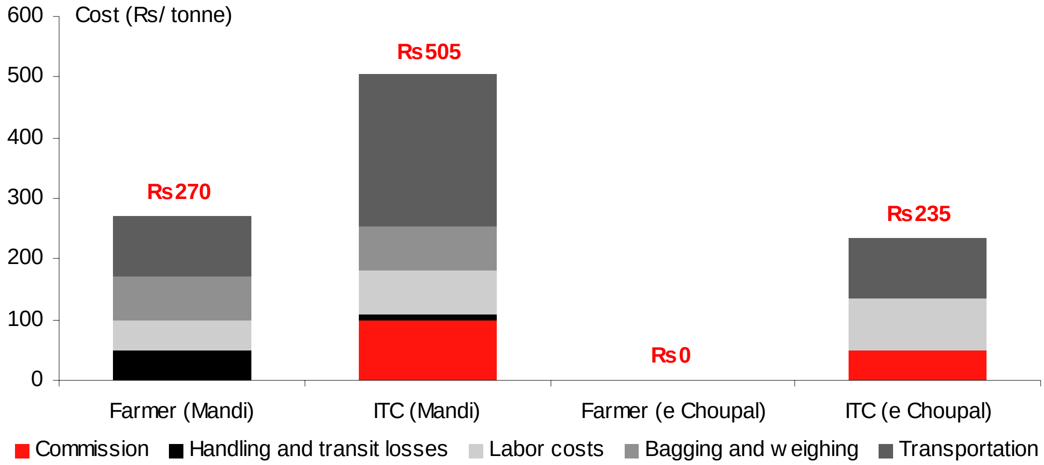
Agriculture contributes close to 23% of India's GDP and employs almost two-thirds of the country's workforce. ITC has used modern resources and methods that can be practically deployed to profitably overcome rural constraints like fragmented farms, weak infrastructure and the involvement of numerous intermediaries, among others.

It has designed the e-choupal model, which ensures delivery of all agricultural goods & services through several product/service-specific partnerships with the leaders in the respective fields. This initiative, comprising 6,500 *choupals* (kiosks/ point of contact: literal meaning: a meeting point for villagers), currently reaches over 3m farmers in the states of Madhya Pradesh, Uttar Pradesh, Rajasthan, Karnataka, Maharashtra, Andhra Pradesh and Kerala.

ITC has made significant investments to create and maintain its own IT network in rural India and to identify and train a local farmer to manage each e-choupal. Each e-choupal costs between US$3,000 and US$6,000 to set up and about US$100 per year to maintain. ITC uses this model to supply the farmers with raw materials such as seed and fertiliser; at the end of harvest season, it also offers to buy the crop directly from the farmer. ITC gains from direct access to the farmer and to information about conditions on the ground, improving planning and building relationships that increase its security of supply.

Profitability: ITC benefits from net procurement costs that are about 2.5% lower, and the company has more direct control over the quality of what it buys. It has recovered its equipment costs from an e-choupal in the first year of operation and the venture as a whole is profitable. ITC gains additional benefits by using this network as a distribution channel for its products and a source of innovation for new products. The farmers benefit through higher margins as the middle parties are removed (Figure 50). They also benefit from accurate weighing, faster processing time and prompt payment. Additionally, they gain access to a wide range of information, including accurate market price knowledge and trends, which help them decide when, where and at what price to sell. This initiative also gives ITC an undisputed coverage and advantage at procuring the harvest from the farmers.

Fig 50 E-choupal systems reduce transactions costs (vs the traditional Mandi)



Source: World Resources Institute, Macquarie Research, April 2007

Choupal Fresh: ITC's fresh food retail chain has been rolled out in urban India and leverages its extensive backward linkages with farmers and supply chain efficiencies. It stocks fresh horticulture produce like fruits and vegetables. Stores also act as hubs for procurement from farmers. In addition, the company has set up a complete cold chain to ensure the availability of fresh products in the market, besides direct linkages with the farmers for sourcing farm fresh produce.

Fig 51 ITC – regional and peer group valuations

Company	Ticker	Country	Market Cap (US$m)	Price Perf. (1 yr %ch)	3 year fwd** EPS CAGR (%)	EBIDTA Margin (FY06) (%)	PAT Margin (FY06) (%)	EV/ EBIDTA (FY06) (x)	Trailing PER (x)	Fwd PER (FY07E) (x)	Fwd PER (FY08E) (x)	P/BV (FY06) (x)	RoCE (FY06) (%)	RoE (FY06) (%) @	Net Debt/ Equity (%)	PEG ratio @
Global peers																
British American Tobacco	BATS LN	UK	16,773	15.3	12	19.4	19.4	10.8	17.3	15.1	13.9	5.1	84.6	29.0	74	1.3
Gallaher Group	GLH LN	UK	3,797	36.4	9	14.7	14.7	12.8	18.4	16.4	15.5	22.9	117.7	187.9	551	1.8
Imperial Tobacco	IMT LN	UK	7,813	33.7	10	26.9	26.9	11.5	18.5	16.8	15.2	28.5	nm	134.6	634	1.6
Swedish Match	SWMA SS	Sweden	4,925	13.5	0	18.1	18.1	11.0	15.0	16.5	15.1	14.6	36.5	63.3	226	nm
Altadis	ALT SM	Spain	9,138	29.8	23	3.6	3.6	12.4	27.3	20.2	18.1	18.2	n/a	51.3	287	0.9
Altria Group	MO US	US	148,571	35.2	-8	17.1	17.1	10.0	13.2	16.7	15.7	3.7	71.1	31.9	32	nm
Reynolds American	RAI US	US	19,021	22.6	6	14.2	14.2	9.8	15.7	14.6	14.1	2.7	71.2	17.8	29	2.6
UST Inc	UST US	US	9,649	44.4	5	28.1	28.1	11.0	19.0	18.0	17.2	nm	50.5	717.9	859	3.6
Vector Group	VGR US	US	1,067	4.1	n/a	8.4	8.4	9.1	28.9	19.7	n/a	11.2	29.0	n/a	-10	n/a
Carolina Group (Loews)	CG US	US	13,667	66.5	6	24.9	24.9	n/a	17.6	16.7	15.7	n/a	n/a	n/a	-110	2.8
Average			23,442		7	17.6	17.6	10.9	19.1	17.1	15.6	13.4	65.8	38.6	257	2.1
Regional peers																
Japan Tobacco	2914 JP	Japan	48,862	35.9	-1	4.4	4.4	8.0	25.1	27.6	25.5	3.0	14.9	12.4	-38	-29.0
Rothmans	ROC CN	Canada	1,210	-0.9	1	15.3	15.3	5.1	14.4	13.5	14.0	10.2	56.4	64.7	16	9.5
BAT- Malaysia*	ROTH MK	Malaysia	3,811	7.0	12	27.2	16.6	13.4	22.2	17.8	16.4	21.3	48.7	94.1	75	1.5
KT&G*	033780 KS	Korea	9,545	6.9	9	35.7	22.7	10.8	20.0	18.0	17.8	2.8	14.5	15.0	-17	1.9
Gudang Garam	GGRM IJ	Indonesia	2,338	3.3	34	3.8	3.8	7.7	21.1	13.5	11.8	1.6	17.4	14.9	40	0.4
Average			13,153		11	17.3	12.5	9.0	20.5	18.1	17.1	7.8	30.4	40.2	15	3.3
Indian peers																
Godfrey Philips	GP IN	India	282	-24.7	n/a	8.7	8.7	15.5	23.7	n/a	n/a	3.3	30.9	17.1	16	n/a
VST Industries	VST IN	India	121	-33.5	n/a	12.9	12.9	6.5	4.5	n/a	n/a	2.7	112.0	24.3	-6	n/a
GTC Industries	GTC IN	India	61	-37.6	n/a	12.6	12.6	13.0	11.1	n/a	n/a	8.0	29.3	n/a	70	n/a
Average			155		n/a	11.4	11.4	11.7	13.1	n/a	n/a	4.7	57.4	20.7	27	n/a
Indian consumer peers																
Hindustan Lever	HLVR IN	India	10,464	-27.6	-1	15.2	15.2	27.3	23.8	28.0	24.5	20.7	195.9	63.0	12	nm
Nestle	NEST IN	India	2,360	-10.8	13	12.5	12.5	17.1	32.7	29.7	25.5	28.6	87.9	91.9	-36	2.2
Colgate-Palmolive	CLGT IN	India	1,075	-21.8	28	12.4	12.4	31.4	33.0	24.4	20.2	16.5	117.2	52.1	-9	0.9
Tata Tea	TT IN	India	855	-29.0	7	9.6	9.6	8.6	11.7	11.2	10.2	2.3	34.2	15.1	90	1.6
Dabur	DABUR IN	India	1,865	8.1	21	12.5	12.5	24.4	35.0	28.8	23.9	16.1	77.2	50.0	18	1.4
Britannia	BRIT IN	India	684	-34.0	12	8.6	8.6	20.6	20.1	18.0	16.0	5.4	60.2	29.5	-22	1.5
Marico	MRCO IN	India	905	16.0	34	7.7	7.7	23.0	42.6	30.4	23.6	14.2	40.2	36.3	69	0.9
Godrej Consumer	GCPL IN	India	792	-21.4	21	17.3	17.3	29.1	28.0	23.6	19.1	43.1	273.7	188.7	53	1.1
GSK Consumer	SKB IN	India	502	-22.3	19	11.0	11.0	11.4	20.7	17.0	14.5	4.5	21.5	21.3	-39	0.9
Average			2,167	-15.9	17	11.9	11.9	21.4	27.5	23.5	19.7	16.8	100.9	60.9	15	1.3
ITC Ltd*	**ITC IN**	**India**	**13,697**	**-22.4**	**9**	**33.3**	**22.5**	**15.6**	**25.5**	**21.8**	**23.0**	**6.3**	**36.9**	**26.7**	**-40**	**2.5**
ITC (normalised)					**20**											**1.1**

* Macquarie estimates ** 3-year EPS CAGR for companies under coverage; 2-year EPS CAGR, based on IBES consensus, for all others

@ Ignoring significant outliers while calculating average

Source: Bloomberg, Macquarie Research, April 2007

Important disclosures:

Recommendation definitions

Macquarie Australia/New Zealand
Outperform – return >5% in excess of benchmark return (>2.5% in excess for listed property trusts)
Neutral – return within 5% of benchmark return (within 2.5% for listed property trusts)
Underperform – return >5% below benchmark return (>2.5% below for listed property trusts)

Macquarie Asia
Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie First South Securities (South Africa)
Outperform – expected return >+5%
Neutral – expected return from -5% to +5%
Underperform – expected return <-5%

Recommendations – 12 months

Note: Quant recommendations may differ from Fundamental Analyst recommendations

Recommendation proportions

	AU/NZ	Asia	RSA
Outperform	44.37%	58.37%	42.20%
Neutral	44.01%	21.30%	46.80%
Underperform	11.62%	20.33%	11.00%

For quarter ending 31 March 2007

Volatility index definition*

This is calculated from the volatility of historic price movements.

Very high–highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low–medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.
* Applicable to Australian/NZ stocks only

Financial definitions

All "Adjusted" data items have had the following adjustments made:
Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / efpowa*
ROA = adjusted ebit / average total assets
ROA Banks/Insurance = adjusted net profit /average total assets
ROE = adjusted net profit / average shareholders funds
Gross cashflow = adjusted net profit + depreciation
*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

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