

May 28, 2008

Rating	Market Performer
Price	Rs209
Target Price	Rs214
Implied Upside	2.3%
Sensex	16,276

(Prices as on May 27, 2008)

Trading Data

Market Cap. (Rs bn)	788.0
Shares o/s (m)	3,768.6
Free Float	60.3%
3m Avg. Daily Vol ('000)	6,731.8
3m Avg. Daily Value (Rs m)	1,378.1

Major Shareholders

Promoters	—
Foreign	14.0%
Domestic Inst.	38.4%
Public & Others	47.6%

Stock Performance

(%)	1M	6M	12M
Absolute	0.7	13.8	28.0
Relative	5.2	28.0	15.1

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



Source: Bloomberg

ITC

VAT resolved; conversion the next issue

- Results:** ITC reported net sales growth of 16.7% in Q4FY08 to Rs39.3bn, against our expectation of Rs39.2bn. This was led by 48.1% growth in non-cigarette FMCG business and a healthy performance by the agri and paperboards segments. Net profit grew by 13.1% to Rs7.4bn, lower than our expectations of Rs7.6bn. OPM declined by 100bps to 26.6%.
- For FY08,** ITC reported revenue growth of 12.8% to Rs139.5bn, inline with our expectation. Operating margin declined marginally by 41bps to 31.6% and PAT grew by 15.6% to Rs31.2bn, lower than expected.
- Segmental business performance:** Cigarette business grew 8.8% YoY for the quarter and 7.7% for the year. The company witnessed 2% volume growth in Q4FY08 and 1% volume decline for the year. It stopped production of non-filters in March; however, we understand that the company might introduce offerings in non-filters with revised prices if conversion is low. Likewise, non-cigarette FMCG business grew by 48.1%, while PBIT margin declined to 16.0% due to high expenses pertaining to personal care product launches. Agri business reported growth in sales aided by soybean trade, offsetting losses in previous quarters.
- Valuation:** We remain positive on the 'multiple growth drivers' business model of the company. However, at current valuations, the stock is trading at a fair price. Due to uncertainty regarding conversion from non-filters to filters, we revise our FY09E EPS to Rs9.4 and FY10E EPS to Rs10.5, thereby revising our rating from Outperformer to Market Performer with an SOTP price target of Rs214.

Key financials (Y/e March)	FY07	FY08	FY09E	FY10E
Revenue (Rs m)	123,693	139,475	158,852	190,467
Growth (%)	26.3	12.8	13.9	19.9
EBITDA (Rs m)	39,564	44,039	50,385	56,368
PAT (Rs m)	27,000	31,201	35,543	39,667
EPS (Rs)	7.2	8.3	9.4	10.5
Growth (%)	18.4	15.4	13.9	17.6
Net DPS (Rs)	3.2	3.5	4.0	4.4

Source: Company Data; PL Research

Profitability & valuation	FY07	FY08	FY09E	FY10E
EBITDA margin (%)	32.0	31.6	31.7	29.6
RoE (%)	24.2	27.8	27.5	26.8
RoCE (%)	26.2	26.3	26.3	26.0
EV / sales (x)	6.3	5.5	4.8	3.9
EV / EBITDA (x)	19.7	17.5	15.1	13.3
PE (x)	29.1	25.3	22.2	19.9
P / BV (x)	7.5	6.6	5.7	5.0
Net dividend yield (%)	1.5	1.7	1.9	2.1

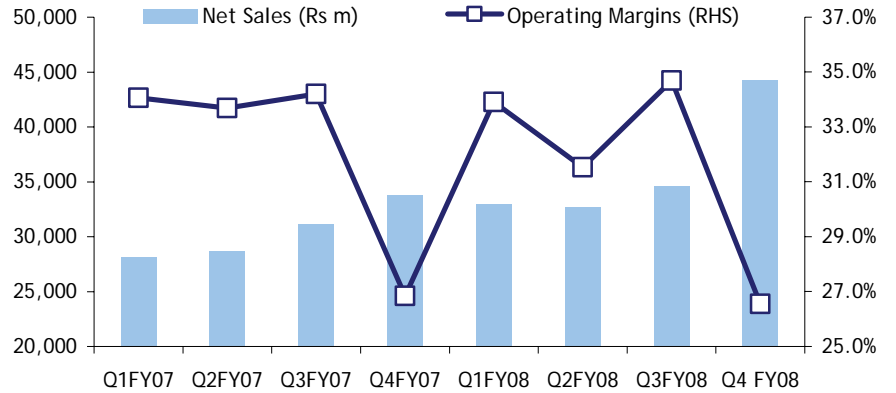
Source: Company Data; PL Research

Anand Mour
AnandMour@PLIndia.com
+91-22-6632 2244

Mihir P Shah
MihirPShah@PLIndia.com
+91-22-6632 2258

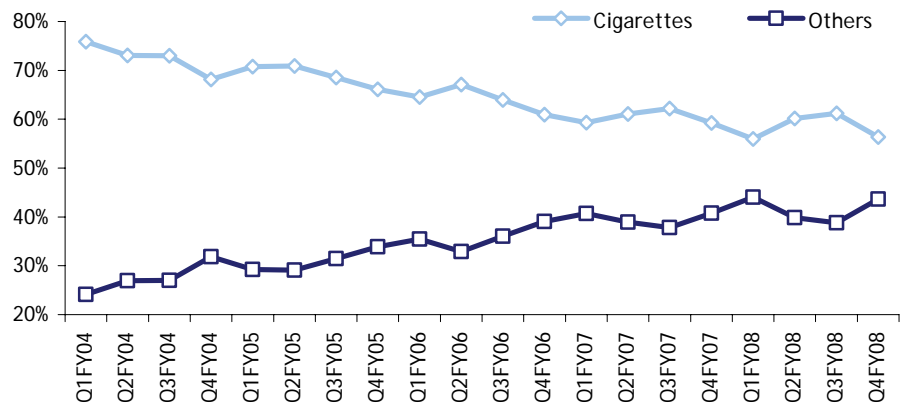
Highlights

Net revenue grew by 16.7%, with operating margin declining by 100bps



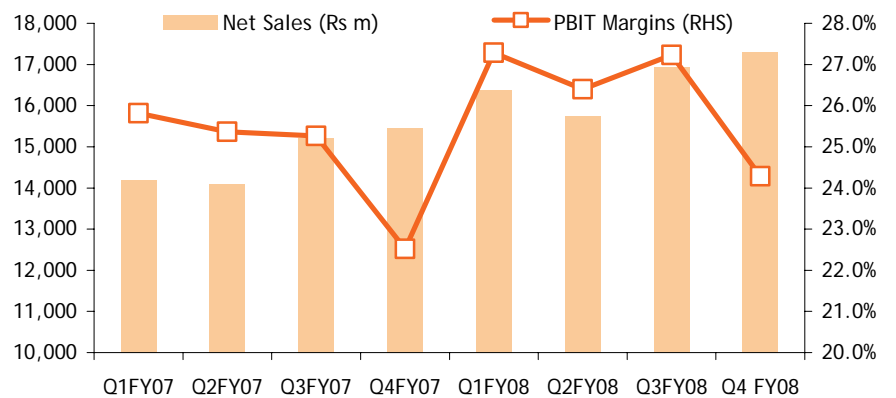
Source: Company Data, PL Research

ITC's gross revenue dependence on cigarettes has come down commendably



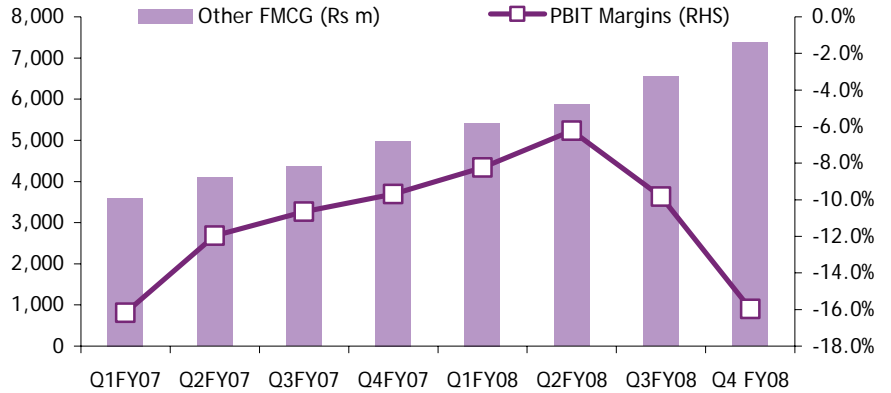
Source: Company Data, PL Research

Net revenue from cigarettes grew with 2% volume growth in Q4FY08



Source: Company Data, PL Research

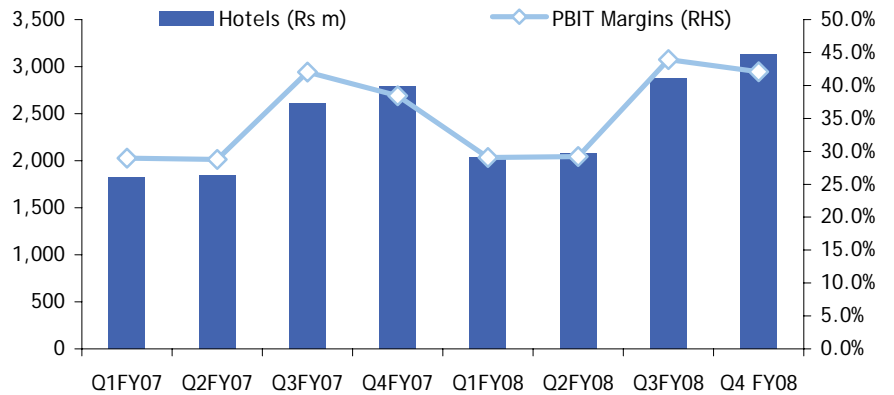
Other FMCG businesses continue robust growth in revenue but with higher losses



Source: Company Data, PL Research

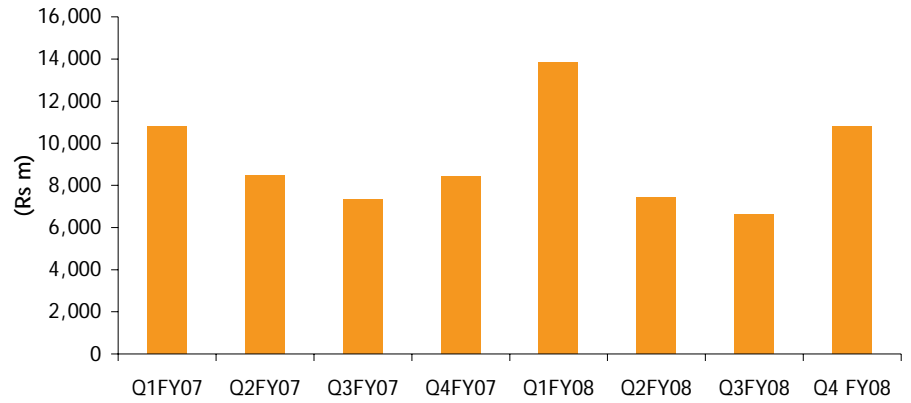
Sunfeast and *Aashirvaad* brands have nearly crossed Rs10bn sales each. Expenses pertaining to personal care products have constrained PBIT margin in this quarter. We believe *Bingo* should turn profitable in Q3FY09. However, overall segmental losses should remain same at absolute level.

Hotels - sustained revenue growth with premium product mix; however, margins grew consistently YoY



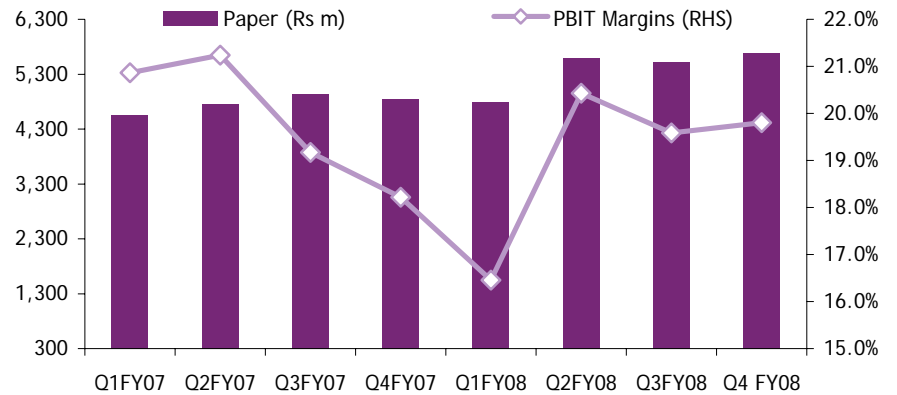
Source: Company Data, PL Research

Agriculture - soybean trade boost growth



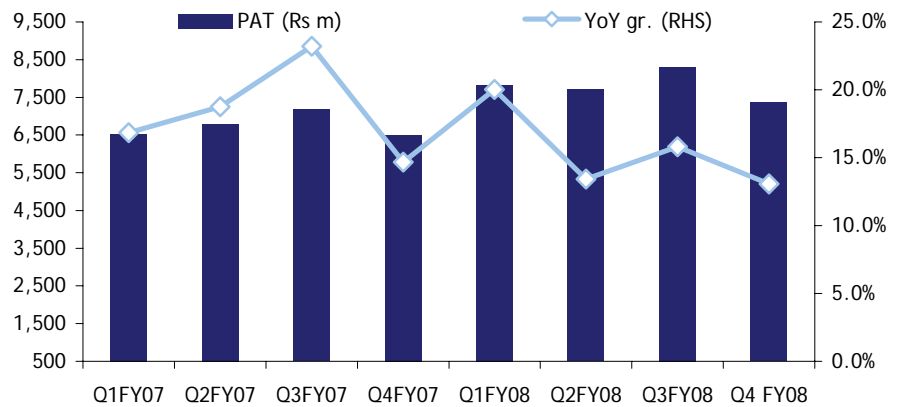
Source: Company Data, PL Research

Paper - consistent performance in revenue growth....



Source: Company Data, PL Research

Leads to PAT growth of 13%, while PAT margin declines



Source: Company Data, PL Research



In FY08, VAT implementation on cigarettes was managed with about 21% price hike and 1% volume decline, in line with our expectations. However, in FY09, the bigger issue would be conversion of non-filters smokers to filters. The company has currently stopped production of non-filters; however, we believe that the company may resort to production of non-filters in case the conversion is low. We do not expect any conversion from micros to filters as the price gap is about 3.5x, however conversion from plains would be reasonable. The sensitivity of Scissors Plain's conversion to filters highlights its importance.

Sensitivity of Scissors Plain conversion (*ceteris paribus*)

Scissors Plain conversion	Volume	Avg. price	Change in gross margin	Gross sales	PBIT	EPS
30%	-10.0%	14.2%	130	142,120	38,510	9.35
40%	-8.9%	13.9%	171	143,470	38,880	9.40
50%	-8.1%	13.7%	214	144,480	39,150	9.43
60%	-7.1%	13.5%	254	145,790	39,510	9.49
70%	-6.1%	13.2%	298	146,970	39,830	9.52

Source: PL Research

We assume overall 8% volume decline with 4% price hike on filters accompanied with 9% increase in average price realization due to better product mix.

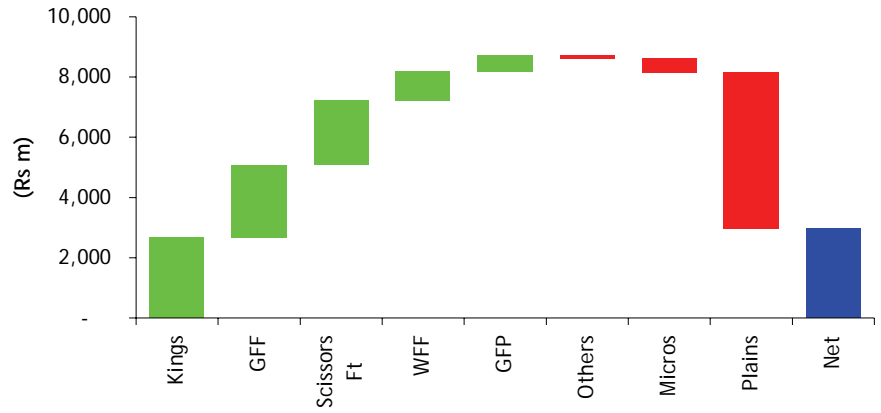
Improvement in portfolio mix

	FY08	FY09E	Price increase	Volume change
Portfolio mix				
KSFT	9%	11%	10%	12%
MKFT	6%	7%	0%	1%
RSFT	67%	82%	4%	12%
Plains	12%	0%	No production	
Micros	5%	0%		
Overall			14%	-8%
Product Mix			9%	
Filters			4%	12%

Source: PL Research

Key drivers of growth in this year would be price hikes on KSFT and GFF with high volume growth. The equal important is the conversion of Scissors Plain to Scissors Filters.

Key growth drivers of profitability in FY09E



Source: PL Research

Valuation: We remain positive on the ‘multiple growth drivers’ business model of the company. However, at current valuations, the stock is trading at a fair price. Due to uncertainty regarding conversion from non-filters to filters, we revise our FY09E EPS to Rs9.4 and FY10E EPS to Rs10.5, thereby revising our rating from Outperformer to Market Performer with an SOTP price target of Rs214.

Segmental break-up

(Rs m)

Y/e March	Q4FY08	Q4FY07	YoY gr. (%)	Q3FY08	FY07	FY08	YoY gr. (%)
Revenue							
FMCG - cigarettes	35,830	32,940	8.8	35,294	128,337	138,256	7.7
FMCG - others	7,384	4,985	48.1	6,554	17,044	25,111	47.3
Hotels	3,393	3,043	11.5	3,136	9,857	11,002	11.6
Agri business	10,781	9,287	16.1	6,629	36,914	38,684	4.8
Paperboards, paper & packaging	6,197	5,333	16.2	6,040	21,001	23,643	12.6
Total	63,585	55,589	14.4	57,653	213,152	236,696	11.0
Inter-segment	5,124	2,876	78.2	4,134	18,101	23,137	27.8
Gross sales	58,461	52,714	10.9	53,519	195,051	213,559	9.5
Sales mix (%)							
FMCG - cigarettes	56.3	59.3	(291)	61.2	60.2	58.4	180
FMCG - others	11.6	9.0	265	11.4	8.0	10.6	(261)
Hotels	5.3	5.5	(14)	5.4	4.6	4.6	(2)
Agri business	17.0	16.7	25	11.5	17.3	16.3	97
Paperboards, paper & packaging	9.7	9.6	15	10.5	9.9	10.0	(14)
PBIT							
FMCG - cigarettes	8,701	7,417	17.3	9,611	31,721	36,340	(12.7)
FMCG - others	(1,179)	(483)	143.9	(645)	(2,020)	(2,635)	(23.3)
Hotels	1,428	1,171	22.0	1,377	3,508	4,108	(14.6)
Agri business	370	87	327.3	278	1,235	1,292	(4.4)
Paperboards, paper & packaging	1,227	972	26.3	1,183	4,168	4,531	(8.0)
Total	10,547	9,162	15.1	11,804	38,613	43,636	(11.5)
PBIT margins %							
FMCG - cigarettes	24.3	22.5	177	27.2	24.7	26.3	(157)
FMCG - others	(16.0)	(9.7)	627	(9.8)	(11.9)	(10.5)	(136)
Hotels	42.1	38.5	362	43.9	35.6	37.3	(175)
Agri business	3.4	0.9	250	4.2	3.3	3.3	1
Paperboards, paper & packaging	19.8	18.2	159	19.6	19.8	19.2	68
Total	16.6	16.5	10	20.5	18.1	18.4	(32)
PBIT mix %							
FMCG - cigarettes	82.5	80.9	155	81.4	82.2	83.3	(113)
FMCG - others	(11.2)	(5.3)	(590)	(5.5)	(5.2)	(6.0)	81
Hotels	13.5	12.8	76	11.7	9.1	9.4	(33)
Agri business	3.5	0.9	256	2.4	3.2	3.0	24
Paperboards, paper & packaging	11.6	10.6	103	10.0	10.8	10.4	41



Q4FY08 result overview

(Rs m)

Y/e March	Q4FY08	Q4FY07	YoY gr. (%)	Q3FY08	FY07	FY08	YoY gr. (%)
Net sales	39,344	33,719	16.7	34,580	123,693	139,475	12.8
Expenditure							
Raw material	18,445	14,884	23.9	13,130	53,849	60,167	11.7
<i>% of NS</i>	<i>46.9</i>	<i>44.1</i>		<i>38.0</i>	<i>43.5</i>	<i>43.1</i>	
Personnel	1,911	1,632	17.1	1,906	6,301	7,333	16.4
<i>% of NS</i>	<i>4.9</i>	<i>4.8</i>		<i>5.5</i>	<i>5.1</i>	<i>5.3</i>	
Other expenditure	8,542	7,899	8.1	7,547	23,979	27,936	16.5
<i>% of NS</i>	<i>21.7</i>	<i>23.4</i>		<i>21.8</i>	<i>19.4</i>	<i>20.0</i>	
Total expenditure	28,897	24,416	18.4	22,583	84,129	95,436	13.4
OPBDIT	10,447	9,303	12.3	11,997	39,564	44,039	11.3
<i>OP margin (%)</i>	<i>26.6</i>	<i>27.6</i>		<i>34.7</i>	<i>32.0</i>	<i>31.6</i>	
Other income	1,637	1,023	60.0	1,374	3,365	6,109	81.5
PBDIT	12,084	10,326	17.0	13,371	42,929	50,148	16.8
Depreciation	1,215	922	31.8	1,097	3,629	4,385	20.8
Interest	27	(1)	NM	18	33	46	40.4
PBT	10,842	9,404	15.3	12,256	39,267	45,718	16.4
Prov. for tax	3,485	2,897	20.3	3,948	12,267	14,517	18.3
<i>% of PBT</i>	<i>32.1</i>	<i>30.8</i>		<i>32.2</i>	<i>31.2</i>	<i>31.8</i>	
PAT	7,356	6,507	13.1	8,307	27,000	31,201	15.6



Prabhudas Lilladher Pvt. Ltd.

3rd Floor, Sadhana House, 570, P. B. Marg, Worli, Mumbai-400 018, India.

Tel: (91 22) 6632 2222 Fax: (91 22) 6632 2209

PL's Recommendation Nomenclature

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

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