

2Q slightly disappointing but long term story intact

2Q results disappoint slightly

ITC's 2Q net profit grew 18.7% to Rs6.8bn, 4% lower than our expectations, owing primarily to lower EBIT margins across most of the businesses. Total turnover grew 26%, led by 14% growth in cigarettes and 50% growth in non-cigarettes. Total EBIT grew 19%, led by cigarette EBIT growth of 15% and non-cigarette growth of 44%.

Cigarettes - Steady so far, headwinds ahead

We estimate 2Q vol. gr. of ~8-9%, in line with our expectations. However margin expansion of only 30bp is disappointing. For 1H, margin gain has been 80bp, in line with historic trends. Over the next few months, we expect stock sentiment to be hit by overhang of excise & VAT levy in Feb 2007. We believe tax increases of up to 10% will not have any significant detrimental impact on ITC's cigarette business.

Non-cigarettes - Lowest margin Agri business outperforms

Key highlights in the non-cigarette businesses – FMCG losses increased Y-o-Y on account of large promotional events; going forward losses likely to fall sequentially in 3Q and 4Q; Agri turnover grew 87% and EBIT grew 49%, led largely by leaf tobacco and commodity exports, 2H is generally leaner for agri; hotels and paper performed largely in line with our expectations.

Stock View - Buy but limited triggers near term

We believe ITC is an excellent stock to play the long term consumption growth story in India, especially in rural India. But near term we expect the stock to consolidate given concerns regarding cigarette tax increase in Feb-2007, increasing advertising restrictions on cigarettes, possibility of large greenfield capex in the paper business and gestation costs for new FMCG businesses.

Estimates (Mar)

(Rs)	2005A	2006A	2007E	2008E	2009
Net Income (Adjusted - mn)	18,278	22,758	27,634	33,280	NA
EPS	4.89	6.06	7.36	8.86	NA
EPS Change (YoY)	16.5%	24.1%	21.4%	20.4%	NA
Dividend / Share	2.07	2.65	3.53	4.61	NA
Free Cash Flow / Share	2.88	3.52	5.54	6.69	NA
GDR EPS (US\$)	0.112	0.136	0.163	0.196	NA
GDR Dividend / Share (US\$)	0.047	0.059	0.078	0.102	NA

Valuation (Mar)

	2005A	2006A	2007E	2008E	2009
P/E	38.38x	30.94x	25.48x	21.16x	NA
Dividend Yield	1.10%	1.41%	1.88%	2.46%	NA
EV / EBITDA*	24.25x	20.31x	16.48x	13.71x	NA
Free Cash Flow Yield*	1.53%	1.88%	2.95%	3.57%	NA
Adjusted BV	NA	NA	NA	NA	NA

* For full definitions of *iQmethod*SM measures, see page 5.

Equity | India | Industrials/Multi-Industry
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Merrill Lynch

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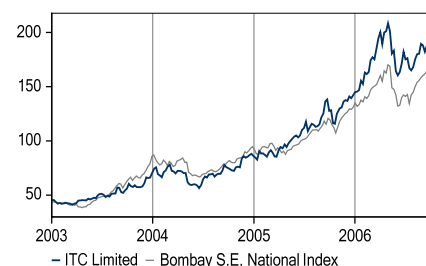
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Stock Data

Price (Common / GDR)	Rs187.50 / 4.16
Price Objective	Rs200.00 / 4.45
Date Established	24-Jul-2006 / 24-Jul-2006
Investment Opinion	C-1-7 / C-1-7
Volatility Risk	HIGH / HIGH
52-Week Range	Rs116.00-Rs212.70
Market Value (mn)	US\$15,581
Shares Outstanding (mn)	3,755.2 / 3,755.2
Average Daily Volume	1,004,641
ML Symbol / Exchange	ITCTF / BSE
ML Symbol / Exchange	ITCTY / OTU
Bloomberg / Reuters	ITC IN / ITC.BO
ROE (2007E)	28.7%
Net Dbt to Eqty (Mar-2006A)	-8.2%
Est. 5-Yr EPS / DPS Growth	15.0% / 15.0%
Free Float	67.0%



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Refer to important disclosures on page 6 to 7. Analyst Certification on page 4. Price Objective Basis/Risk on page 4.

*iQprofile*SM ITC Ltd.

Key Income Statement Data (Mar)	2005A	2006A	2007E	2008E	2009
(Rs Millions)					
Sales	76,302	97,860	117,831	139,202	NA
Gross Profit	31,582	37,576	45,869	54,833	NA
Sell General & Admin Expense	(6,878)	(7,671)	(8,605)	(9,680)	NA
Operating Profit	24,704	29,905	37,264	45,153	NA
Net Interest & Other Income	1,934	2,742	3,078	3,431	NA
Associates	NA	NA	NA	NA	NA
Pretax Income	26,638	32,646	40,342	48,584	NA
Tax (expense) / Benefit	(8,360)	(9,888)	(12,708)	(15,304)	NA
Net Income (Adjusted)	18,278	22,758	27,634	33,280	NA
Average Fully Diluted Shares Outstanding	3,741	3,755	3,755	3,755	NA

Key Cash Flow Statement Data

Net Income (Reported)	18,278	22,758	27,634	33,280	NA
Depreciation & Amortization	3,129	3,323	3,675	4,067	NA
Change in Working Capital	(7,965)	(5,591)	(2,956)	(3,465)	NA
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	4,133	(1,255)	1,242	1,052	NA
Cash Flow from Operations	17,574	19,236	29,595	34,934	NA
Capital Expenditure	(6,786)	(6,013)	(8,800)	(9,800)	NA
(Acquisition) / Disposal of Investments	887	(256)	0	0	NA
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	(5,899)	(6,269)	(8,800)	(9,800)	NA
Shares Issue / (Repurchase)	NA	NA	NA	NA	NA
Cost of Dividends Paid	(5,601)	(8,817)	(11,347)	(14,962)	NA
Cash Flow from Financing	(2,566)	(8,162)	(11,187)	(14,962)	NA
Free Cash Flow	10,789	13,223	20,795	25,134	NA
Net Debt	1,897	(7,361)	(16,809)	(26,981)	NA
Change in Net Debt	(7,864)	(6,061)	(9,448)	(10,172)	NA

Key Balance Sheet Data

Property, Plant & Equipment	40,770	43,460	48,584	54,317	NA
Other Non-Current Assets	38,747	35,170	35,170	35,170	NA
Trade Receivables	5,278	5,480	6,456	7,628	NA
Cash & Equivalents	557	8,558	18,166	28,338	NA
Other Current Assets	29,559	37,581	44,012	50,991	NA
Total Assets	114,910	130,249	152,389	176,443	NA
Long-Term Debt	2,454	1,197	1,357	1,357	NA
Other Non-Current Liabilities	3,761	3,248	3,651	4,137	NA
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	30,338	35,781	44,686	54,495	NA
Total Liabilities	36,553	40,226	49,694	59,989	NA
Total Equity	78,357	90,023	102,695	116,454	NA
Total Equity & Liabilities	114,910	130,249	152,389	176,443	NA

*iQmethod*SM - Bus Performance*

Return On Capital Employed	22.6%	23.3%	25.3%	26.9%	NA
Return On Equity	25.8%	27.0%	28.7%	30.4%	NA
Operating Margin	32.4%	30.6%	31.6%	32.4%	NA
EBITDA Margin	36.5%	34.0%	34.7%	35.4%	NA

*iQmethod*SM - Quality of Earnings*

Cash Realization Ratio	1.0x	0.8x	1.1x	1.0x	NA
Asset Replacement Ratio	2.2x	1.8x	2.4x	2.4x	NA
Tax Rate (Reported)	31.4%	30.3%	31.5%	31.5%	NA
Net Debt-to-Equity Ratio	2.4%	-8.2%	-16.4%	-23.2%	NA
Interest Cover	NM	NM	NM	NM	NA

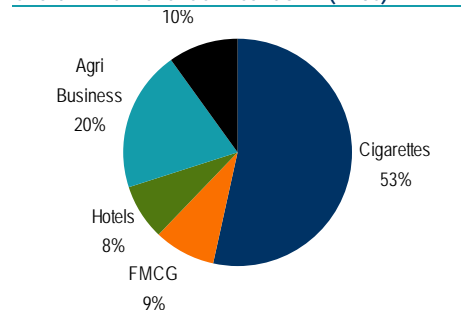
Key Metrics

* For full definitions of *iQmethod*SM measures, see page 5.

Company Description

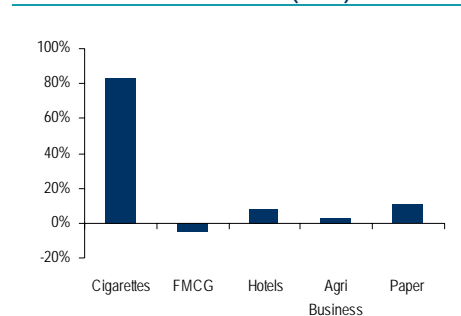
ITC is India's largest cigarette company with about 70%+ volume share and 85%+ value share. Cigarettes account for 59% of turnover and 89% of EBIT. The company has diversified into non-tobacco businesses, such as consumer products, apparel retailing, hotels, paper, and agricultural exports. Key strengths: (1) extensive distribution, (2) strong brands across price segments, and (3) a healthy balance sheet.

Chart 1: ITC Revenue Breakdown (FY06)



Source: ITC

Chart 2: ITC EBIT Breakdown (FY06)



Source: ITC

Stock Data

Shares / GDR	1.00
Price to Book Value	6.9x

Result Highlights

Table 1: Q2 Result Highlights

	Q2 FY06	Q2 FY07	% chg	Q1 FY06	Q1 FY07	% chg
Gross Turnover	37,382	46,249	24%	38,761	46,341	20%
Excise duty	15,550	17,372		16,092	17,844	0.1
As %	41.6%	37.6%		41.5%	38.5%	
Net turnover	21,832	28,876	32%	22,669	28,498	26%
EBITDA	8,232	9,727	18%	8,268	9,706	17%
EBITDA margin	37.7%	33.7%		36.5%	34.1%	
Depreciation	830	910	9.6%	801	876	9.5%
EBIT	7,369	8,818	20%	7,467	8,829	18%
EBIT margin	33.8%	30.5%		32.9%	31.0%	
Interest	(3)	35		11	7	
Other income	781	795	1.8%	578	849	47.1%
Profit before tax	8,152	9,578	17.5%	8,034	9,672	20.4%
Pre-tax margin	37.3%	33.2%		35.4%	33.9%	
Total tax	2,429	2,782		2,631	3,149	0.2
Tax rate	29.8%	29.0%		32.7%	32.6%	
		0.0				
Reported profit	5,723	6,796	18.7%	5,403	6,523	20.7%
Net margin	26.2%	23.5%		23.8%	22.9%	
Extraordinary income / (exp)	-	-		180	-	
Adjusted profit	5,723	6,796	18.7%	5,583	6,523	16.8%

Source: ITC

Table 2: ITC Segment Results

	Q2 FY06	Q2 FY07	% chg	Q1 FY06	Q1 FY07	% chg
<u>Turnover Breakdown</u>						
Gross cigarettes	27,231	31,017	14%	28,431	31,592	11%
Others	2,469	4,096	66%	2,003	3,597	80%
Hotels	1,540	2,010	31%	1,469	1,988	35%
Agri Business	4,656	8,688	87%	7,539	11,111	47%
Paper & packaging	4,700	5,220	11%	4,607	5,015	9%
Total Turnover	40,595	51,031	25.7%	44,049	53,302	21.0%
<u>EBIT Breakdown</u>						
Cigarettes	6,830	7,866	15.2%	6,946	8,156	17.4%
Others	(353)	(490)	38.6%	(547)	(582)	6.4%
Hotels	276	578	109.7%	293	576	96.1%
Agri Business	309	461	49.4%	363	471	29.7%
Paper & packaging	919	1,109	20.7%	896	1,046	16.8%
Total EBIT	7,979	9,524	19.4%	7,952	9,667	21.6%
<u>EBIT margin</u>						
Gross cigarette margin	25.1%	25.4%	0.3%	24.4%	25.8%	1.4%
Others	-14%	-12%	2.4%	-27%	-16%	11.1%
Hotels	18%	29%	10.9%	20%	29%	9.0%
Agri Business	7%	5.3%	-1.3%	4.8%	4.2%	-0.6%
Paper & packaging	19.5%	21.2%	1.7%	19.4%	20.9%	1.4%

Source: ITC

Price Objective Basis & Risk

Our PO of Rs200 is based on our target current year PEG of 1.25x. This is in line with the average for the consumer sector in India and is justified by the steady growth profile and high cash generative ability of its tobacco business. Key risks are higher than expected tax increases in cigarettes and stiffer competition.

Analyst Certification

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31 October 2006

*iQmethod*SM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

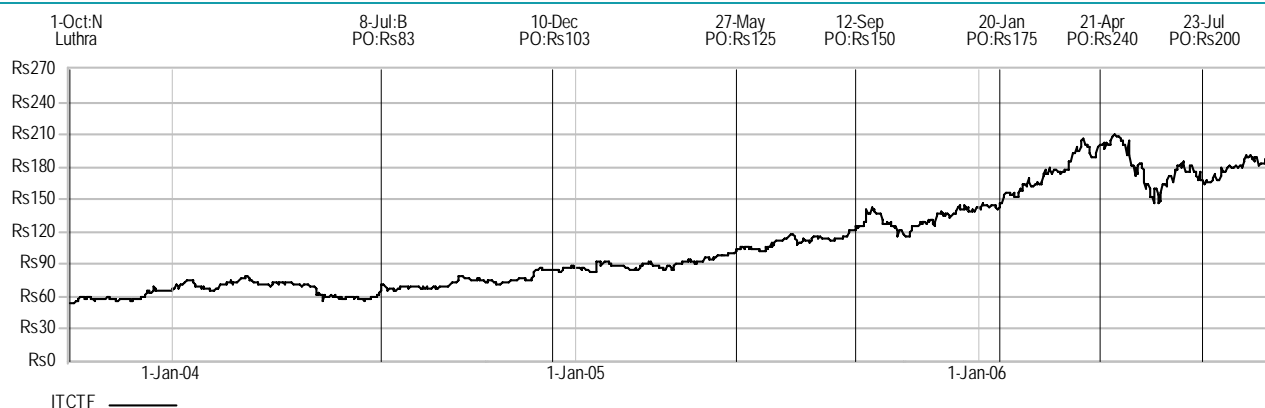
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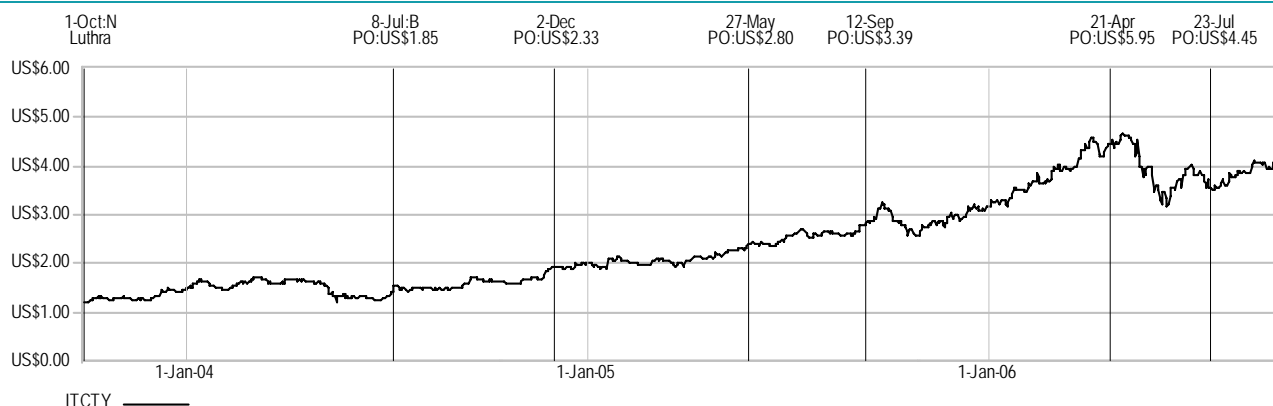
ITCTF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

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ITCTY Price Chart



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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	30	56.60%	Buy	8	26.67%
Neutral	17	32.08%	Neutral	2	11.76%
Sell	6	11.32%	Sell	3	50.00%

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