ITC (ITC.BO)

Excise Hike Steeper Than Expected

- **Excise increase** – In 2008-09 budget, excise duty on non-filter cigarettes has been increased – for non filter plains, excise has gone up from Rs0.562/stick to Rs1.323/stick, whereas that for micros has gone up from Rs0.168/stick to Rs0.819/stick. Excise on filter cigarettes has not been increased; however, the overall weighted excise duty increase for ITC works out to 16%.

- **ITC likely to pass on excise duty hike** – Micros and plains constitute 20% of ITC's revenues and <10% of profits. We expect ITC to pass on the excise duty hikes through price increases. However, we believe ITC is unlikely to pass on the entire excise duty increase through price hikes only in low end micros and plains. It will most likely be an increase spread across the portfolio. Price hikes are likely to have an adverse impact on cigarette volumes. Our FY09 cigarette volume growth assumption is 4%. However, we believe an improving product mix is likely to drive higher margins for the cigarette business.

- **Will ITC exit plains**? – In the new excise structure, duties on plains will be higher than the RSFT cigarettes. We believe ITC is better off exiting the plains segment and introducing an RSFT brand at a lower price. Currently, plains are priced at Rs1.5-1.75/stick, whereas micros are priced at Rs2-2.5/stick.

- **Tough on small players** – Smaller players, like VST and GPI, which mainly manufacture plains and micros and have a 15% overall market share may find it tough to pass on the excise hikes. We believe that larger players like ITC can cross subsidize the non-filter lower end cigarettes and will gain market share from the smaller non-filter players.

Buy/Low Risk	**1L**
Price (29 Feb 08)	Rs204.00
Target price	Rs247.00
Expected share price return	21.1%
Expected dividend yield	1.7%
Expected total return	**22.8%**
Market Cap	Rs768,525M US$19,278M

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

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	22,354	6.00	10.0	34.0	8.4	26.4	1.3
2007A	27,000	7.18	19.5	28.4	7.4	27.7	1.5
2008E	33,176	8.82	22.9	23.1	6.3	29.2	1.7
2009E	40,466	10.76	22.0	19.0	5.3	30.2	2.1
2010E	49,613	13.19	22.6	15.5	4.4	31.1	2.5

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	34.0	28.4	23.1	19.0	15.5
EV/EBITDA adjusted (x)	21.9	18.4	15.0	12.0	9.5
P/BV (x)	8.4	7.4	6.3	5.3	4.4
Dividend yield (%)	1.3	1.5	1.7	2.1	2.5
Per Share Data (Rs)					
EPS adjusted	6.00	7.18	8.82	10.76	13.19
EPS reported	6.00	7.18	8.82	10.76	13.19
BVPS	24.34	27.74	32.57	38.58	46.13
DPS	2.67	3.10	3.54	4.20	5.00
Profit & Loss (RsM)					
Net sales	97,905	123,693	143,809	168,680	198,073
Operating expenses	-67,955	-87,758	-99,750	-114,208	-130,533
EBIT	**29,950**	**35,935**	**44,060**	**54,472**	**67,539**
Net interest expense	-119	-33	-30	-30	-30
Non-operating/exceptionals	2,411	3,365	3,365	3,366	3,366
Pre-tax profit	**32,242**	**39,267**	**47,395**	**57,808**	**70,875**
Tax	-9,888	-12,267	-14,218	-17,342	-21,262
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**22,354**	**27,000**	**33,176**	**40,466**	**49,613**
Adjusted earnings	22,354	27,000	33,176	40,466	49,613
Adjusted EBITDA	33,274	39,564	48,333	59,334	72,782
Growth Rates (%)					
Sales	30.9	26.3	16.3	17.3	17.4
EBIT adjusted	29.1	20.0	22.6	23.6	24.0
EBITDA adjusted	26.4	18.9	22.2	22.8	22.7
EPS adjusted	10.0	19.5	22.9	22.0	22.6
Cash Flow (RsM)					
Operating cash flow	**19,507**	**22,952**	**31,908**	**42,757**	**52,049**
Depreciation/amortization	3,323	3,629	4,274	4,862	5,242
Net working capital	-2,739	-7,677	-5,542	-2,571	-2,806
Investing cash flow	**-1,797**	**-11,178**	**-16,000**	**-16,000**	**-16,000**
Capital expenditure	-5,382	-15,299	-7,000	-7,000	-7,000
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**-11,201**	**-10,950**	**-17,038**	**-17,832**	**-21,228**
Borrowings	-1,256	812	-2,009	0	0
Dividends paid	-11,347	-13,645	-15,030	-17,832	-21,228
Change in cash	**6,509**	**824**	**-1,131**	**8,925**	**14,821**
Balance Sheet (RsM)					
Total assets	**130,840**	**149,684**	**172,952**	**203,116**	**240,333**
Cash & cash equivalent	9,110	9,544	8,413	17,337	32,157
Accounts receivable	5,480	6,367	9,850	11,553	13,567
Net fixed assets	44,051	56,109	58,835	60,973	62,731
Total liabilities	**40,226**	**45,313**	**50,434**	**57,965**	**66,799**
Accounts payable	21,890	23,848	27,122	31,069	35,527
Total Debt	1,197	2,009	0	0	0
Shareholders' funds	**90,615**	**104,371**	**122,517**	**145,150**	**173,534**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	34.0	32.0	33.6	35.2	36.7
ROE adjusted	26.4	27.7	29.2	30.2	31.1
ROIC adjusted	42.5	39.6	40.5	46.3	54.5
Net debt to equity	-8.7	-7.2	-6.9	-11.9	-18.5
Total debt to capital	1.3	1.9	0.0	0.0	0.0

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Figure 1. FY09 Cigarettes Excise Duty Structure

		Excise Duty		
Segment	**% of Volume**	**FY08 (Rs/Stick)**	**FY09 (Rs/Stick)**	**% Change**
Premium -Kings	10%	1.811	1.811	-
Premium -Longs	5%	1.363	1.363	-
Regular	65%	0.843	0.843	-
Plains	10%	0.562	1.323	135.4
Micros	10%	0.168	0.819	387.5
Weighted Avg. Excise/Stick (Rs)		**0.870**	**1.011**	**16.2**

Source: Citi Investment Research

ITC

Company description

ITC is the leading cigarette manufacturer and marketer in India with about 74% share by value. The group is 32% owned by BAT. The company's cigarette portfolio carries strong brands such as Wills, Gold Flake, India Kings and Scissors, and two of BAT's global brands, Benson & Hedges and State Express 555. Besides tobacco, ITC operates in four other business divisions, namely agri / marine products, hotels, paper & packaging and IT. However, more than 75% of its revenue is from the cigarette business. The group has made significant investments in the hotels, paperboard and processed foods (biscuits, ready-to-eat foods, confectioneries) businesses.

Investment strategy

We rate the stock as Buy/Low Risk (1L) with a target price of Rs247. ITC stock has underperformed the Sensex by 12% over the last 12 months. Post imposition of a 12.5% VAT from FY08 (which ITC passed on through price hikes), the stock witnessed a sharp de-rating on concerns pertaining to volume declines. However, we believe that the worst is now behind us for ITC and that risk-reward is now turning favorable. The stock performance has picked up over the last 3 months driven by lower than expected volume decline; with improving volumes going forward, we believe the stock is likely to be re-rated further. Our analysis also suggests that consumer down trading from high end brands towards mid end brand (regular filters) may not have a negative impact on cigarette margins - on the contrary cigarette operating margins may surprise positively. If this scenario were to play out, then cigarette EBIT would grow higher than our estimates.

Valuation

Our target price of Rs247 is based on 23x FY09E earnings. We believe that ITC stock is a re-rating candidate, driven by cigarette volume recovery and strong growth of its foods portfolio. The stock has witnessed a strong re-rating over FY05-FY07, driven by strong cigarette volume growth in a strong economic growth environment. During this period, the stock traded between 18x-29x forward P/E, with an average of 24x P/E. However post imposition of 12.5%

VAT from FY08, the stock witnessed a sharp de-rating on concerns pertaining to volume declines. However, volumes have started to improve and we expect them to start growing from FY09E. With rising volumes, the stock is likely to be re-rated. Our target P/E multiple of 23x is towards the mid-point of last 3 years trading multiple range. If volume growth were to revert back to 7%-8% levels, we believe that the stock multiples could look up further. We are assuming 4% volume growth in FY09E and 6% growth in FY10E. ITC has a relatively stable earnings stream, so P/E is our primary valuation methodology.

Risks

We rate ITC as Low Risk because the company operates in branded businesses and its earnings volatility is low. With most of its earnings coming from the tobacco segment, ITC is most at risk from controls and the government's tax policy. Perceived as being a "sin" industry, the stock is prone to negative share price reactions. Other significant risks for the company are dilution in capital efficiency from investments in non-tobacco businesses and the possible acquisitions of capital intensive businesses that fail to enhance value. Upside risks to our target price include continuation of the government's policy of moderating excise taxes and a sharper-than-expected increase in dividend payout. If any of these factors has a greater impact than we expect, the stock could have difficulty achieving our target price.

Appendix A-1

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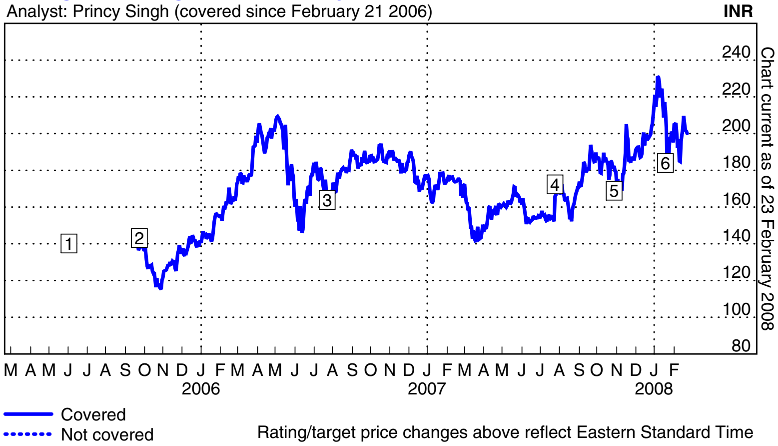
ITC (ITC.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Princy Singh (covered since February 21 2006)



#	Date	Rating	Target Price	Closing Price
1:	2 Jun 05	3L	*88.33	NA
2:	23 Sep 05	3L	*92.00	137.75
3:	23 Jul 06	3L	*130.00	164.30
4:	25 Jul 07	*1L	*195.00	165.85
5:	28 Oct 07	1L	*215.00	182.40
6:	18 Jan 08	1L	*247.00	212.60

*Indicates change.

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