ITC Ltd.

Price Objective Change **BUY**

Equity | India | Industrials/Multi-Industry
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Merrill Lynch

Higher Earnings, Higher PO

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Our PO has increased to Rs240

We believe ITC offers further upside led by strong consumer demand and hence growing cigarette volumes. Our PO of Rs240 is based on our target P/E to growth multiple of 1.3x for FY07E. This is in line with its historic trends and is also in line with valuations of large cap consumer stocks in India.

Earnings upgraded on stronger volumes

We have raised our EPS by 3% in FY06E; 8% in FY07E and 13% in FY08E. We now expect earnings to grow 24% in FY07E and 20.4% in FY08E. This is led by accelerating volume growth in cigarettes and paper. We expect cigarette volumes to grow 9% CAGR in FY07E and 08E (vs. 5% earlier). In Paper, new capacity will likely boost volume growth to 7% CAGR versus our flat expectation earlier.

Immense underutilized pricing power

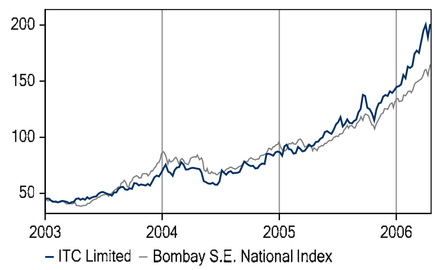
We estimate cigarette prices have increased merely 2.5% pa in FY06 and FY07 and have been skewed towards premium cigarettes (~20% of vol). Prices for a balanced portfolio have not increased for more than 3 years now. In an improving consumer demand scenario potential for price increases in these brands is increasing which should lead to earnings upside. For example we estimate a Rs2/pack (ie 10%) price increase in Gold Flake Filter can increase EPS by ~8% in FY07.

Should you worry about ITC's valuation?

ITC trades at ~100% premium to tobacco stocks across the world and ~50% premium to the Sensex. In our opinion the premium is justified given that it is growing its already high market share in perhaps one of the fastest growing cigarette markets globally. It offers among the highest earnings growth in the global tobacco space and in India twice the Sensex earnings growth rate.

Stock Data

Price (Common / GDR)	Rs200.85 / $4.96
Price Objective	Rs240.00 / 5.95
Date Established	21-Apr-2006 / 21-Apr-2006
Investment Opinion	C-1-7 / C-1-7
Volatility Risk	HIGH / HIGH
52-Week Range	Rs90.67-Rs207.90
Market Value (mn)	US$16,670
Shares Outstanding (mn)	3,741.5 / 3,741.5
Average Daily Volume	1,737,432
ML Symbol / Exchange	ITCTF / BSE
ML Symbol / Exchange	ITCTY / OTU
Bloomberg / Reuters	ITC IN / ITC.BO
ROE (2006E)	27.0%
Net Dbt to Eqty (Mar-2005A)	2.4%
Est. 5-Yr EPS / DPS Growth	15.0% / 15.0%
Free Float	67.0%



Estimates (Mar)

(Rs)	2004A	2005A	2006E	2007E	2008E
Net Income (Adjusted - mn)	15,581	18,278	22,603	27,973	33,745
EPS	4.19	4.89	6.04	7.48	9.02
EPS Change (YoY)	– – –	16.5%	23.7%	23.8%	20.6%
Dividend / Share	1.33	2.07	2.72	3.59	4.69
Free Cash Flow / Share	3.73	2.88	6.07	6.11	7.67
GDR EPS (US$)	0.097	0.112	0.136	0.166	0.200
GDR Dividend / Share (US$)	0.031	0.047	0.061	0.080	0.104

Valuation (Mar)

	2004A	2005A	2006E	2007E	2008E
P/E	47.89x	41.11x	33.25x	26.86x	22.27x
Dividend Yield	0.664%	1.03%	1.35%	1.79%	2.34%
EV / EBITDA*	30.59x	25.95x	21.30x	17.32x	14.45x
Free Cash Flow Yield*	1.85%	1.44%	3.02%	3.04%	3.82%
Adjusted BV	– – –	– – –	– – –	– – –	– – –

* For full definitions of *iQmethod* SM measures, see page 7.

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Refer to important disclosures on page 8 to 9. Analyst Certification on page 6. Price Objective Basis/Risk on page 6.

iQprofile SM ITC Ltd.

Key Income Statement Data (Mar)	2004A	2005A	2006E	2007E	2008E
(Rs Millions)					
Sales	64,704	76,302	94,606	108,421	123,390
Gross Profit	28,023	31,582	38,688	47,314	56,589
Sell General & Admin Expense	(6,833)	(6,878)	(8,143)	(9,314)	(10,654)
Operating Profit	21,190	24,704	30,544	38,000	45,935
Net Interest & Other Income	2,001	1,934	2,452	2,837	3,327
Associates	---	---	---	---	---
Pretax Income	23,191	26,638	32,997	40,837	49,262
Tax (expense) / Benefit	(7,610)	(8,360)	(10,394)	(12,864)	(15,518)
Net Income (Adjusted)	15,581	18,278	22,603	27,973	33,745
Average Fully Diluted Shares Outstanding	3,715	3,741	3,741	3,741	3,741
Key Cash Flow Statement Data					
Net Income (Reported)	15,581	18,278	22,603	27,973	33,745
Depreciation & Amortization	2,416	3,129	3,369	3,709	4,049
Change in Working Capital	4,139	(7,965)	2,135	(1,247)	(1,650)
Deferred Taxation Charge	---	---	---	---	---
Other Adjustments, Net	(1,453)	4,066	554	887	1,007
Cash Flow from Operations	20,716	17,574	28,699	31,365	37,200
Capital Expenditure	(6,845)	(6,786)	(6,000)	(8,500)	(8,500)
(Acquisition) / Disposal of Investments	(184)	887	0	0	0
Other Cash Inflow / (Outflow)	---	---	---	---	---
Cash Flow from Investing	(7,029)	(5,899)	(6,000)	(8,500)	(8,500)
Shares Issue / (Repurchase)	---	---	---	---	---
Cost of Dividends Paid	(4,188)	(5,601)	(8,817)	(11,473)	(15,146)
Cash Flow from Financing	(4,038)	(2,566)	(8,580)	(11,473)	(15,146)
Free Cash Flow	13,871	10,789	22,699	22,865	28,700
Net Debt	868	1,897	(11,985)	(23,376)	(36,930)
Change in Net Debt	(9,610)	(7,864)	(13,882)	(11,391)	(13,554)
Key Balance Sheet Data					
Property, Plant & Equipment	35,512	40,770	43,401	48,193	52,644
Other Non-Current Assets	---	---	---	---	---
Trade Receivables	2,302	5,278	3,888	4,456	5,071
Cash & Equivalents	340	557	14,675	26,067	39,621
Other Current Assets	16,870	9,529	10,482	11,530	12,683
Total Assets	100,905	114,910	134,030	154,867	178,213
Long-Term Debt	1,209	2,454	2,691	2,691	2,691
Other Non-Current Liabilities	---	---	---	---	---
Short-Term Debt	---	---	---	---	---
Other Current Liabilities	7,404	11,517	14,709	18,904	24,115
Total Liabilities	37,413	36,553	44,818	52,827	62,222
Total Equity	63,492	78,357	89,212	102,040	115,991
Total Equity & Liabilities	100,905	114,910	134,030	154,867	178,213
iQmethod SM **- Bus Performance***					
Return On Capital Employed	23.6%	22.6%	23.2%	25.4%	27.0%
Return On Equity	26.7%	25.8%	27.0%	29.3%	31.0%
Operating Margin	32.7%	32.4%	32.3%	35.0%	37.2%
EBITDA Margin	36.5%	36.5%	35.8%	38.5%	40.5%
iQmethod SM **- Quality of Earnings***					
Cash Realization Ratio	1.3x	1.0x	1.3x	1.1x	1.1x
Asset Replacement Ratio	2.8x	2.2x	1.8x	2.3x	2.1x
Tax Rate (Reported)	32.8%	31.4%	31.5%	31.5%	31.5%
Net Debt-to-Equity Ratio	1.4%	2.4%	-13.4%	-22.9%	-31.8%
Interest Cover	NM	NM	NM	NM	NM

Key Metrics

* For full definitions of *iQmethod* SM measures, see page 7.

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.

Stock Data

Shares / ADR	1.00
Price to Book Value	8.4x

Should you worry about ITC's valuation?

ITC has been perhaps the best performing tobacco stock globally over the last 3 years. It now trades at P/E of 33xFY07E and 26.8xFY08E. This implies a 50% premium to the Indian market and 100% premium to global tobacco valuations. Most of the tobacco stocks across the world trade at one-year forward P/E of 14x except for Japan Tobacco (B-1-7, ¥470,000.00) which is at 19x.

Though absolute valuations appear high, it is worthwhile to recap the ITC story which in our opinion justifies its premium:

- **Consistent and high earnings growth** – In the global tobacco space, ITC is one of the few companies that has delivered consistent earnings growth in the last decade. Over the last 5 years, it earnings have grown 18% CAGR and now we forecast growth to further accelerate to 24% in FY06 and FY07 and 20% plus in FY08 making it one of the fastest growing cigarette companies in the world.

- **Attractive market** – India is among the fastest growing cigarette markets in the world. **ITC's cigarette volume growth has accelerated from 3-4% two years back to now 9-10%.** We expect this growth rate to be sustained for a number of reasons – growing income levels, favorable demographics and mild price increases. From a longer term perspective India offers a structurally attractive market for cigarettes since ~80% of tobacco in India is consumed in the form of bidis which are exempted from taxes.

- **ITC is virtually a monopoly** – An extensive distribution network and strong brands across price segments give ITC a dominate market share of over 75%. The rest of the market is fragmented between 3 players. More importantly, we think that ITC's share can remain intact because of strict advertising restrictions which are a major entry barrier for a global tobacco brand to enter India. Secondly, we think global tobacco companies may not have the product width that is required to succeed in the Indian market which has large income disparities.

- **Diversification brings cyclicality but the cycles are currently positive** – ITC's diversification into Paper, Hotels and FMCG has often been a sore point. However, we note that these businesses are in a rising cycle. We expect the hotel cycle to persist for at least 18 months and perhaps even longer given our forecast of GDP growth of 7% plus over the next two years. ITC's paper business is essentially packaging for consumer products and hence the current environment is positive for this division. In the case of FMCG, we expect the losses to now start decelerating.

- **Strong balance sheet** – ITC is net cash positive. At end-FY07, we estimate cash and cash equivalent to be Rs54.5bn i.e. about 50% of its total capital employed. The issue in ITC however has been the use of surplus cash. While ITC continues to build its non-tobacco businesses, we believe management will remain committed to maintaining ROCE of over 25%. We do expect capex to rise in FY07E to ~Rs8.5bn versus historic trend of Rs6bn p.a. but this is unlikely to impact dividend payout which has been rising gradually and was 42% in FY05.

Cigarettes – Underutilized pricing power

We estimate ITC has increased prices (on a weighted average basis across its entire cigarette portfolio) by merely 2.5% in FY06 and another 2.5% in FY07. This compares to increases of 7% plus across most of the consumer categories during the last 18 months. Rising income levels and improving consumer demand typically leads to stronger pricing outlook but we have not seen this yet playing out in ITC.

Secondly, ITC has historically raised prices higher than excise duty increases. But trends in FY06 and FY07 indicate that ITC is only just passing the excise increase to the consumers. Milder prices increases over the last few years also mean that should excise / VAT increases in FY08 be ‘harsh’, the consumer has relatively more affordability to pay for the higher prices. Of course had ITC executed sharper price increases, it would not have had the benefit of current volume growth of 9-10% but we note that ITC’s earnings are more sensitive to price changes relative to volume changes.

Another important characteristic of ITC’s pricing strategy in the recent past is that it has been heavily skewed towards premium cigarettes which account for only ~20% of its total volumes. For the rest of the portfolio, prices have not increased since 2003 and in some cases since 2001. Given that (1) ITC is a market leader across most price segments and (2) competitive position has not deteriorated, in fact has improved, we believe stable prices for such a long duration clearly imply that ITC has immense latent pricing power and the impact on earnings can be substantial. For instance, Gold Flake Filter’s price was last increased in April 2003. We estimate an increase of Rs2/pack ie 10% will lead to earnings increasing by at least 8%. This is not factored in our forecasts.

Our earnings model for FY07E builds in cigarette volume growth of 9.5% and retail price (excluding mix benefit) increase of 3.3%. Of this we estimate price increase of 2.5% has been implemented so far and hence we expect some more price increases to come through the rest of the year.

Estimates Upgraded by 8-13% in FY07 and FY08

We have raised our EPS by 3.2% in FY06E; 7.9% in FY07e and 12.8% in FY08E. Our new earnings outlook is as follows: FY06E – Rs6, a growth of 24%; FY07E – Rs7.5, a growth of 24% and FY08E – Rs9, a growth of 21%.

The improving outlook is underpinned by:

- **Cigarette -** volume acceleration – we expect volumes to grow 9-10% versus our earlier expectation of 5% growth. Improving income levels and hence stronger demand outlook is boosting volume growth.

- **Paper** – again volume acceleration – we expect volumes to grow 9% in Fy07E and 5% in FY08E versus our largely flat outlook earlier. ITC is investing in new capacities which should lead to stronger volumes.

Table 1 gives our segment-wise assumptions of net sales and EBIT. We expect contribution of cigarettes to sales remain constant at 55% but share of EBIT to decrease from 85% in FY06E to 80% in FY08E. The declining EBIT share is led by our expectation of reducing losses in the FMCG business.

Table 1: ITC Business Division Forecasts

	FY05A	FY06E	FY07E	FY08E
Net Sales				
Cigarettes	45005	52120	59265	67435
% chg	10.5%	15.8%	13.7%	13.8%
FMCG	4834	8492	10560	12760
% chg	91.9%	75.7%	24.4%	20.8%
Hotels	5730	7520	9024	10500
% chg	125.2%	31.2%	20.0%	16.4%
Agri Business	12207	15869	17456	19202
% chg	-5.1%	30.0%	10.0%	10.0%
Paper	8524.1	10096.3	11557.0	12878.8
% chg	38.6%	18.4%	14.5%	11.4%
Total Net Sales	76300	94098	107862	122776
% chg	17.7%	23.3%	14.6%	13.8%
EBIT				
Cigarettes	22888.4	27612	32489	38197
% chg	12.6%	20.6%	17.7%	17.6%
FMCG	-1952.3	-1738	-1022	-293
% chg	12.0%	-11.0%	-41.2%	-71.3%
Hotels	1409.4	2092	3053	3792
% chg	333.5%	48.4%	45.9%	24.2%
Agri Business	964.1	855	916	989
% chg	7.4%	-11.4%	7.2%	8.0%
Paper	2799.9	3652	4565	5299
% chg	21.8%	30.4%	25.0%	16.1%
Total EBIT	26109.5	32472	40001	47985
% chg	18.1%	24.4%	23.2%	20.0%
EBIT Margin				
Cigarettes	50.9%	53.0%	54.8%	56.6%
FMCG	-40.4%	-20.5%	-9.7%	-2.3%
Hotels	24.6%	27.8%	33.8%	36.1%
Agri Business	7.9%	5.4%	5.2%	5.2%
Paper	32.8%	36.2%	39.5%	41.1%
Total EBIT Margin	34.2%	34.5%	37.1%	39.1%
% Break downs				
Net Sales				
Cigarettes	59%	55%	55%	55%
FMCG	6%	9%	10%	10%
Hotels	8%	8%	8%	9%
Agri Business	16%	17%	16%	16%
Paper	11%	11%	11%	10%
Total Turnover	100%	100%	100%	100%
EBIT				
Cigarettes	88%	85%	81%	80%
FMCG	-7%	-5%	-3%	-1%
Hotels	5%	6%	8%	8%
Agri Business	4%	3%	2%	2%
Paper	11%	11%	11%	11%
Total EBIT	100%	100%	100%	100%

Source: ITC, ML Forecasts

Price Objective Basis & Risk

Our PO of Rs240 is based on our target PE to growth multiple of 1.3x for FY07E. This is in line with ITC's historic trends and is also similar to PEG multiples of other large cap consumer companies in India. At Rs240, PEG of 1.3x implies a P/E of 32xFY07E which is largely similar to the current FY06E P/E of 33.1x. Risks are lower volume growth and steep increase in excise duty.

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iQmethod SM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
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	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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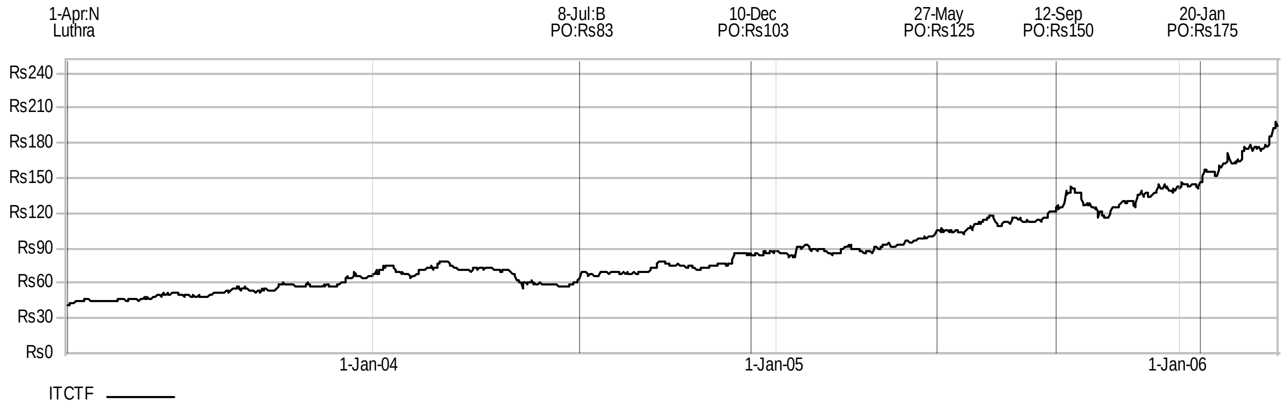
Important Disclosures

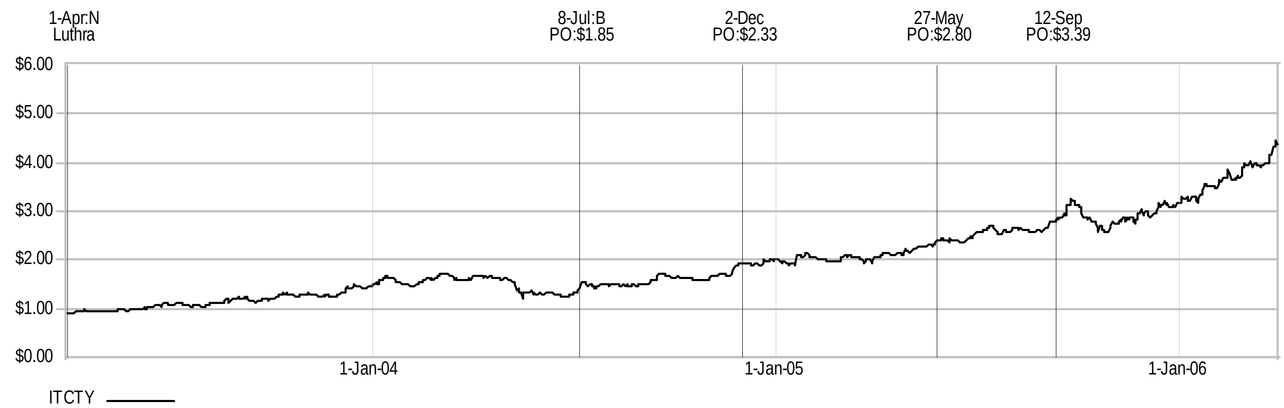
ITCTF Price Chart



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

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of March 31, 2006.

ITCTY Price Chart



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Investment Rating Distribution: Industrials/Multi-Industry Group(as of 31 Mar 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	32	58.18%	Buy	8	25.00%
Neutral	19	34.55%	Neutral	5	26.32%
Sell	4	7.27%	Sell	0	0.00%

Investment Rating Distribution: Global Group(as of 31 Mar 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1145	40.29%	Buy	393	34.32%
Neutral	1474	51.86%	Neutral	430	29.17%
Sell	223	7.85%	Sell	44	19.73%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months.

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