Morgan Stanley
JM MORGAN STANLEY

MORGAN STANLEY RESEARCH
ASIA/PACIFIC

JM Morgan Stanley Securities Private Limited+

Hozefa Topiwalla
Hozefa.Topiwalla@morganstanley.com
+91 22 2209 7808

Nillai Shah
Nillai.Shah@morganstanley.com
+91 22 2209 7157

December 8, 2006

Stock Rating
Overweight

Industry View
Attractive

ITC Ltd.

It's All About ITC's Rural Initiative

Our visit to understand ITC's rural initiative was enlightening: We visited ITC's E-Choupal infrastructure in Khakrkheda and Bahrkheda villages (population of less than 4,000), 50-100 kms from Bhopal airport. We also visited ITC's Choupal Saagar in Sehore to increase our understanding of the company's rural marketing initiatives. We were highly impressed by the commitment made by ITC to transform the lives of the farmers with whom it works.

E-Choupal – leverage to Information Technology: ITC is building strong trust and relationships with soya and wheat farmers in Madhya Pradesh by: 1. giving farmers the power of information, thus improving transparency in agri product sourcing; 2. completely eliminating hidden costs incurred by the farmer in the sale of agri products; 3. delivering best-quality farm and agri inputs to farmers at competitive rates; and 4. introducing non-profit services to farmers to improve farm productivity. The E-Choupal initiative also creates a direct marketing channel, eliminating wasteful intermediation and multiple handling, thus reducing transaction costs and improving logistics efficiency. ITC claims that this initiative enables it to save around 3-5% in transaction costs in the supply chain.

Choupal Saagars – a two-way transaction hub: ITC's Choupal Saagars provide procurement services, product retail, healthcare, insurance and soil testing facilities to farmers. We estimate that each Choupal Saagar can contribute around Rs10 mn to ITC's EBIT. ITC aims to set up 100 Choupal Saagars over the next three years and 700 long term.

Reiterate Overweight: ITC remains in a sweet spot as all its existing businesses are witnessing strong growth momentum. We see the key trigger for the stock as a potential reduction in losses in its non-tobacco FMCG businesses. We reiterate our Overweight rating on the stock.

Key Ratios and Statistics

Reuters: ITC.BO Bloomberg: ITC IN GDR: ITCq.L
India Consumer

Price target	Rs220.00
Shr price, close (Dec 7, 2006)	Rs186.65
Mkt cap, curr (mn)	Rs700,908
52-Week Range	Rs212.70-133.95
Sh out, basic, curr (mn)	3,755.2
EV, curr (mn)	Rs666,286
Net debt/cap (07e) (%)	(67.9)
ROE (07e) (%)	30.3
Shrs out, basic, per-end (07e) (mn)	3,755
S'hldr eqty (07e) (mn)	Rs103,267
RNOA (07e) (%)	41.5

Fiscal Year (Mar)	2006	2007e	2008e	2009e
ModelWare EPS (Rs)*	6.05	7.27	8.50	9.77
EPS, basic, rpt'd (Rs)	5.93	7.27	8.50	9.77
Revenue, net (Rs mn)	97,905	117,871	141,338	170,367
ModelWare net inc (Rs mn)	22,732	27,302	31,912	36,676
P/E	32.2	25.7	22.0	19.1
P/BV	8.1	6.8	5.9	5.2
EV/EBITDA	21.0	16.7	14.1	12.0
Div yld (%)	1.4	1.8	2.1	2.5

* = Please see explanation of Morgan Stanley ModelWare later in this note.
e = Morgan Stanley Research estimates

Investment Case

ITC's rural initiative is likely to be one of the key long-term growth drivers for the company, in our view. In addition to its social objectives, ITC intends to achieve the following two commercial objectives: first, it wants to improve its competitive advantage in the packaged foods business by building a strong sourcing supply chain; and, second, it is keen to build a robust rural marketing business to capitalize on the long-term growth potential in rural India.

We visited ITC's E-Choupal infrastructure in Khakrkheda and Bahrkheda villages (population of less than 4,000), 50-100 kms from Bhopal airport. We also visited ITC's Choupal Saagar in Sehore to increase our understanding of the company's rural marketing initiatives. We were highly impressed by the commitment made by ITC to transform the lives of the farmers with whom it works. This note discusses ITC's initiatives and plans.

ITC Investing for the Long Term

In our view, ITC has begun building a strong and competitive rural marketing business that has the potential to reap dividends in the long term. ITC is building strong trust and relationships with soya and wheat farmers in Bhopal by making social and commercial commitments. Importantly, ITC is already reaping the benefits from its initiatives in its packaged/processed foods business by building a sourcing advantage over its competitors. Apart from the quantitative benefits discussed below, ITC is securing a number of very important qualitative benefits for its packaged foods businesses: 1. the ability to buy and store large volumes of agri produce during the peak season – which gives it a material cost advantage; 2. access to high and consistent quality of agri produce, which improves its yields on packaged foods; and 3. scale buying benefits, which also give it a competitive advantage. However, in our view, the key benefits for ITC will come in the long run, as it scales up its rural marketing initiatives.

Strong Rural Marketer

It seems that ITC's broad commercial vision is to become a strong rural marketing company. Nearly two-thirds of the Indian population are dependent on agriculture for their livelihood, hence, long term, we think rural marketing (rural-led growth) will be adopted as a key strategy by most firms.

In our view, most companies are unlikely to be able to set up their own rural distribution and marketing networks, and many will need to rely on third-party networks, such as that which ITC is building. ITC appears to be building on its first-mover advantage in rural marketing to capitalize upon this huge long-term business potential.

Adopting a Different Approach

ITC is adopting a different approach/methodology to enable it to capture the potential opportunity in rural marketing. Rural consumers currently have limited purchasing power and hence ITC is focusing on ways to improve farmers' income levels/buying power and then create demand for products that ITC can market to them.

ITC's model has been specifically designed to tackle the challenges posed by the unique features of Indian agriculture (e.g. fragmented farms, weak infrastructure and the involvement of numerous intermediaries). ITC is attempting to address this issue through E-Choupal. According to ITC, such a market-led business model can enhance the competitiveness of Indian agriculture and trigger a virtuous cycle of higher productivity, higher incomes, and enlarged capacity for farmer risk management, larger investments and higher quality and productivity. Further, growth in rural incomes should also unleash the latent demand for industrial goods so necessary for the continued growth of the Indian economy. ITC plans to capitalize on this opportunity in India with the help of E-Choupals and Choupal Saagars.

Company Description

ITC was incorporated in 1910 and is 33%-owned by BAT Industries. It operates in three principal businesses, tobacco and cigarettes (80% of sales), hotels and paper & packaging. The company is the undisputed cigarette leader (67% market share), and has a dominant presence in virtually every segment of the Indian tobacco market. ITC owns five of the top six trademarks in the Indian cigarette industry.

Industry View: Attractive

We believe the industry is on a recovery path driven by a pick-up in rural and urban demand and an improving pricing environment.

MSCI Country: India

Asia Strategist's Recommended Weight: 2.4%
MSCI Asia/Pac All Country Ex Jp Weight: 7.0%

Exhibit 1
Road Leading to the Village

Reproduced by kind permission of ITC.

E-Choupal

Step 1: Building trust and strong bond with farmers
The first step in the process of becoming a distributor of products in the rural areas is to build trust with farmers. ITC has adopted a unique strategy to build trust with farmers and seems to be succeeding via the E-Choupal route.

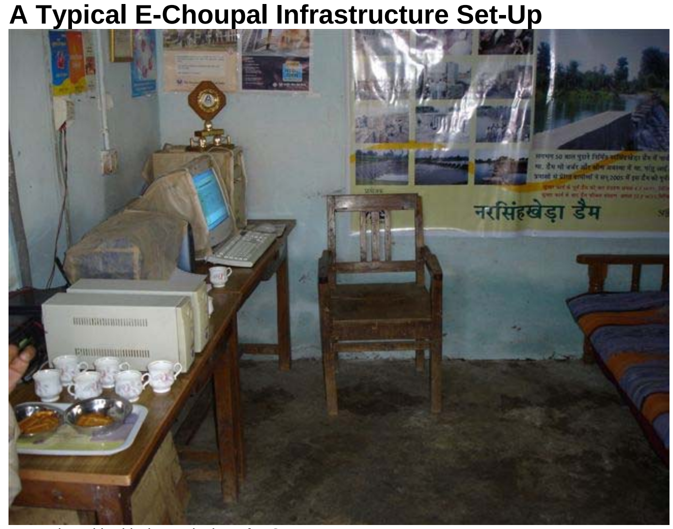
ITC's 'E-Choupal' initiative leverages Information Technology to disintermediate the supply chain. E-Choupal makes use of the physical transmission capabilities of current intermediaries – aggregation, logistics, counter-party risk and bridge financing – while disintermediating them from the chain of information flow and market signals.

The E-Choupal initiative also creates a direct marketing channel, eliminating wasteful intermediation and multiple handling, thus reducing transaction costs and making logistics efficient. The E-Choupal project is already benefiting over 3.5 million farmers. According to ITC, over the next decade, the E-Choupal network will cover over 100,000 villages, representing 1/6th of rural India, and create more than 10 million e-farmers.

Step 2: Empowering farmers with information
ITC has installed village internet kiosks managed by farmers – called *sanchalaks* – which enable the agricultural community to access ready information in their local language on the weather and market prices, disseminate knowledge on scientific farm practices and risk management, facilitate the sale of farm inputs (now with embedded knowledge) and purchase farm produce from the farmers' doorsteps (decision-making is now information-based).

ITC's E-Choupal is located in the house of a trained farmer, or *sanchalak*. The *sanchalak* will typically be a reputed farmer with above-average land holdings, and his house will typically be within walking distance of the houses of most villagers. The role of the *sanchalak* is primarily to educate the farmers on ITC's E-Choupal initiative, give them access to ITC's E-Choupal infrastructure, disseminate real time commodity prices and update them on local weather conditions and information on farming practices. Through the E-Choupal initiative, ITC aims to confer the power of expert knowledge on even the smallest individual farmer.

Exhibit 2
A Typical E-Choupal Infrastructure Set-Up



Reproduced by kind permission of ITC.

The real-time information and customized knowledge provided by E-Choupal enhance the ability of farmers to take decisions, align their farm output with market demand and secure quality and productivity.

Step 3: Making commercial impact by disintermediation
ITC has also begun giving farmers the option to buy farm inputs through E-Choupal, thus giving them access to assured quality inputs from established manufacturers at market prices. As a direct marketing channel, virtually linked to the 'mandi' system for price discovery, E-Choupal attempts to eliminate intermediation and multiple handling, thereby reducing transaction costs. While the farmers benefit through enhanced farm productivity and higher farm gate prices, ITC benefits from a lower net cost of procurement (despite offering better prices to the farmer), having eliminated costs in the supply chain that do not add value. ITC claims that this initiative enables it to save around 3-5% in transaction costs in the supply chain.

In addition to the quantitative benefits, ITC realizes a number of qualitative benefits through its E-Choupal initiative: 1. the ability to buy and store large volumes of agri produce during the peak season – which gives it a material cost advantage (sometimes the price differential between peak season and off season prices can be huge); 2. access to high and consistent quality of agri produce, which improves its yields on packaged foods; and 3. scale buying benefits, which also give it a competitive advantage.

Exhibit 3

Transaction Cost Comparison for Soya Bean

Cost in Rs per MT of Soya Bean		
	Traditional costs	ITC's E-Choupal cost
Farmers Cost		
Trolley Freight to Mandi	120	120
Labour	50	0
Kacchha Adat (Trader)	150	0
Handling Loss	50	0
Sub total	**370**	**120**
% of transaction cost	**3.4**	**1.1**
Processors costs		
Commission to Agents	100	50
Cost of Gunny bags	75	75
Freight to factory	120	0
Handling at Mandi	40	40
Cash disbursement cost		50
Sub total	**335**	**215**
% of transaction cost	**2.2**	**1.4**
Grand total	***705***	***335***
% transaction cost	**6.4**	**3.0**

*Assuming Rs11,000 per tonne as Soya bean cost
Source: Company data, Morgan Stanley Research

ITC's E-Choupal has worked well to identify the key concerns of individual farmers and is putting in place mechanisms to solve the difficulties they face. According to our interviews with two *sanchalaks* and a few farmers in two separate villages in Madhya Pradesh, ITC has been able to address the following four key concerns, thereby building considerable trust and equity with the farming community.

Concern 1: Price transparency

According to the *sanchalaks* we met, one of the biggest problems faced by small farmers is that they get marginalized by the traders and trader cartels at the mandis (government-run wholesale markets).

A typical small farmer has to travel around 10-15 km to reach the mandi to sell his produce. If the farmer is unhappy with the price offered by the traders for his produce, he has three options: first, stay back at the mandi for a couple of days and wait to get a better price; second, take the goods back home and return to the mandi at a later date, thus incurring additional freight costs; and third sell his produce at the prevailing rate in the market and incur some potential loss in value.

ITC's solution: Give farmers the power of information, thus improving transparency.

ITC's E-Choupal has placed the power of information directly into the hands of the farmers. The *sanchalaks* we met were dexterous in the use of their computers and the Internet, having been trained by ITC. ITC's websites are customized to suit local language requirements and are menu-driven. The sanchalak and the farmers are capable of checking the prevailing rates at various mandis and the trend in international prices of their produce. To assist the farmers further, ITC even posts its next day's buying price on the web in the evening to enable farmers to make a more informed decision. Farmers have the option of selling their produce at the mandis or to ITC's sourcing hubs, both of which typically offer similar prices.

Exhibit 4

A Sanchalak with E-Choupal Infrastructure

Reproduced by kind permission of ITC.

Concern 2: Hidden costs at the mandis

A typical farmer incurs an additional labour cost and handling loss at the mandis, which is beyond the farmer's control. The farmer has to unload his entire produce, and get it weighed and filled in gunny bags and thus ends up paying fixed additional labour charges to the workers at the mandis. Also a typical trader uses a part of every batch of produce for sampling, which results in handling loss. ITC estimates that the farmer incurs at least Rs100 per tonne as hidden costs related to labour charges and handling loss.

ITC's solution: Complete elimination of hidden costs

Farmers selling their produce at ITC's warehousing hubs, which are generally close to the mandis, incur no hidden costs. The loaded tractor and trailer is first weighed and then emptied at ITC's storage hub and then the empty tractor and trailer is once again weighed. The farmer is paid for the difference in weight and there are no labour charges involved for handling and no wastage on account of sampling of the produce.

Concern 3: Agri inputs are adulterated

Small farmers typically buy agri inputs, such as seeds, fertilizers and pesticides in limited quantities, depending on the availability of finances and their immediate requirements. The farmers were quite concerned about the high level of adulteration in farm inputs they purchase from traders.

I*TC's solution: Build trust and deliver best-quality farm inputs*

ITC's ultimate object is to market and distribute products to the farmers, agri inputs as well as non-agri products. Through E-Choupal, ITC has educated farmers on best farm practices, farm management and risk management. ITC has begun marketing and distributing quality farm and agri inputs to the farmers. Although this is a very low-margin business (estimated at around 1-3%) ,ITC is building significant goodwill with the farmers and, more importantly, developing a two-way transaction mechanism between itself and the farmers.

Concern 4: Poor knowledge on soil and farm practices

Many farmers lack adequate expertise on the quantity of pesticides and fertilizer required by the soil. This results in a tendency to use agri inputs inefficiently. Also, knowledge of appropriate cropping patterns based on soil moisture, etc, is quite low. This generally leads to low yield and impacts overall farm productivity.

ITC's solution: ITC has begun providing non-profit services to farmers to improve farm productivity

ITC has begun providing non-profit services to farmers, such as soil testing, advice on crop rotation, etc, to improve the yields and productivity of the farmers. This is helping ITC build goodwill and trust with the farming community. Also ITC is playing a direct role in trying to improve farmers' income. These initiatives, although non-commercial currently, are likely to go a long way towards building ITC's rural marketing and distribution business, in our view.

Other Insights from the Trip

- *Sanchalaks* typically earn 0.5% commission on transacted commodity volumes and margins on FMCG products distributed by them. The *sanchalaks* we met make around Rs75,000 p.a., but anecdotal evidence suggests that this is well above average.

- E-Choupal infrastructure typically costs around Rs200,000 per installation. The entire cost is borne by ITC.

- According to the *sanchalaks* we met, the average profitability of a typical soya and wheat farmer in Madhya Pradesh is currently around Rs10,000 per acre. However, this number was very close to zero a few years ago. Importantly, with the significant rise in wheat prices in the recent past, farmers expect their profitability to jump by around 30-50%.

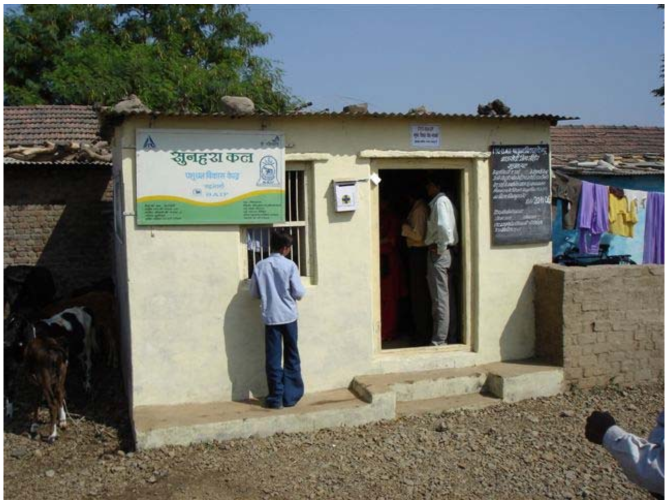
- ITC has begun distributing FMCG products (we saw Colgate's toothpastes, Marico's Parachute coconut oil and Marico's Hair & Care hair oil, along with ITC's biscuits and sugar confectionery products). ITC has also begun distributing electric bulbs and transistor batteries through its E-Choupal network. However, the current volume of FMCG product distribution is very small. ITC has entered into tie-ups with around 50 companies to distribute agri and non-agri products through its rural marketing and distribution infrastructure.

- ITC is also working with various NGOs to initiate welfare programmes, with the aim of ensuring that the infrastructure and healthcare requirements of the villages are met. The initiative is being carried out under the banner 'Sunehra Kal' (translates as 'better future').

- Interestingly, real estate prices for farmland in Bhopal have increased by 7-10x over the last three to four years, leapfrogging farmers' wealth.

Exhibit 5

ITC's Sunehra Kal Initiative



Reproduced by kind permission of ITC.

Progressing Steadily with E-Choupals

Launched in June 2000, the E-Choupal initiative now reaches out to more than 3.5 million farmers growing a range of crops (soyabean, coffee, wheat, rice, pulses, shrimp) in over 36,000 villages through nearly 6,400 kiosks across nine states (Madhya Pradesh, Haryana, Uttaranchal, Karnataka, Andhra Pradesh, Uttar Pradesh, Maharashtra, Rajasthan and Kerela). ITC has plans to extend the E-Choupal initiative to 15 states in total across India, with 20,000 E-Choupals covering 10 million farmers over the next few years. On the anvil are plans to channelise other services related to micro-credit, health and education through the same E-Choupal infrastructure.

Choupal Saagars

Choupal Saagars – ITC's marketing and sourcing hub

Choupal Saagars, in our view, are likely to be ITC's key rural marketing, distribution and sourcing infrastructure. Choupal Saagars are synergistic with the E-Choupal network and serve as the core infrastructure to support ITC's rural marketing and distribution strategy. Choupal Saagars are effectively ITC's two way transaction platform with farmers.

ITC currently has around 11 Choupal Saagars operational in the three states of Madhya Pradesh, Maharashtra and Uttar Pradesh, while nine more are expected to be launched progressively over the next six months. ITC's vision is to open 700 Choupal Saagars across the country. The biggest bottleneck in its roll-out plan is availability of space.

Choupal Saagar Infrastructure

ITC's Choupal Saagars are geared to providing procurement services, product retailing, healthcare, insurance and soil testing facilities.

The infrastructure set-up cost for a typical Choupal Saagar is estimated at around US$1 mn, including the cost of land. The Choupal Saagar we visited was spread across six acres of land close to the highway and just outside Sehore town.

Exhibit 6

Choupal Saagar at Sehore, Madhya Pradesh

Reproduced by kind permission of ITC.

1. The Choupal Saagar outside Sehore has a retail mall with 6,000-7,000 sq ft of retailing area, where it retails agri and farm inputs, FMCG products, apparels, consumer durables, footwear, utensils among other consumer products.

Exhibit 7

Retail Mall at Choupal Saagar

Reproduced by kind permission of ITC.

Exhibit 8

Retail Mall at Choupal Saagar

Reproduced by kind permission of ITC.

2. The Choupal Saagar outside Sehore has open and closed storage for soya and wheat, respectively. The closed storage can accommodate around 6,000 tonnes of wheat. ITC typically receives around 150-500 tonnes of foodgrain per day.

Exhibit 9

Open Warehousing Facility at Choupal Saagar

Reproduced by kind permission of ITC.

Exhibit 10

Enclosed Warehousing Facility at Choupal Saagar

Reproduced by kind permission of ITC.

3. ITC distributes products and services of around 50 other companies with which it has tied up, including Mahindra tractor service shops, Tata Steel shops, BPCL petrol pumps and Appolo healthcare centres.

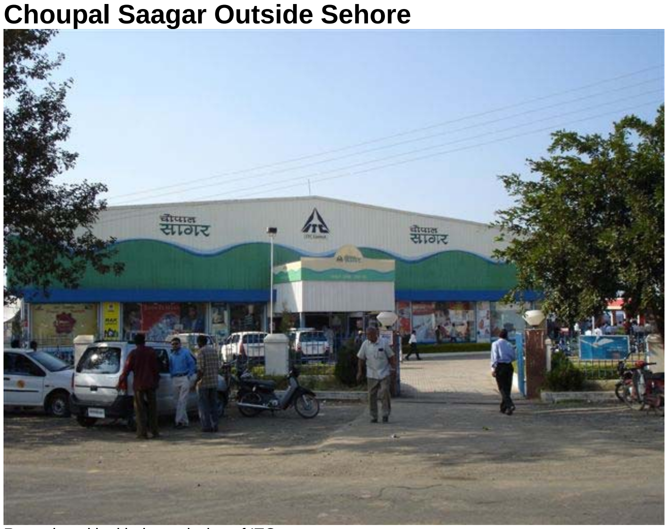
4. A typical Choupal Saagar also has a farmer training centre and a soil testing lab.

Exhibit 11
A Mahindra Tractors Kiosk at Choupal Saagar

Reproduced by kind permission of ITC.

An effective two-way transaction hub
The company buys foodgrains from farmers offering transparent pricing and, more importantly, the entire turnaround time from the procurement of goods to payment to the farmer is crunched to under an hour from around six to seven hours at a typical mandi, in addition to the elimination of hidden costs. Interestingly, the cashier is located right inside the mall to encourage farmers to buy products from the mall after they have received compensation for their produce.

Exhibit 12
Choupal Saagar Outside Sehore



Reproduced by kind permission of ITC.

Interesting facts about Choupal Saagars
It estimated that around 35% products sold by ITC from its mall are agri inputs. The average sales per steady store are currently estimated at around Rs40 million p.a., translating into sales per sq ft of around Rs6,500. ITC expects to invest around US$1 million per Choupal Saagar. Over the next three years, ITC could have around 100 Choupal Saagars and in the long term it plans to set up 700.

Blue Sky analysis for Choupal Saagars
We have carried out a blue sky analysis on the potential EBIT that ITC's agri business/rural marketing business may be able to contribute. Given that each Choupal Saagar can handle around 15,000 tonnes of foodgrains annually, we estimate that it should be able to source food grains worth around Rs225 million annually.

Exhibit 13
Foodgrain Handling Capacity of a Typical Choupal Saagar

Foodgrain handling capacity of each Choupal Saagar (tonnes)	15,000
Foodgrain handling capacity of Choupal Saagar (Value Rs mn)*	225

* Morgan Stanley Research estimate.
Source: Company data, Morgan Stanley Research

Assuming that the company is able to capture 25% of farmers' wallets by selling goods and services, we estimate that ITC could achieve rural marketing business of around Rs56 million per Choupal Saagar.

Exhibit 14
Marketing and Distribution of a Typical Choupal Saagar

Total Value of Foodgrains managed (Rs mn)	225
Share of wallet ITC is able to capture (%)	25
Marketing & Distribution of Products by ITC (Rs bn)	56.3

Source: Morgan Stanley Research estimates

Assuming that ITC earns an EBIT margin of 2.5% of its sourcing and trading of agri products business and 8% on rural marketing and distribution business, we believe it could earn EBIT of Rs10.1mn per Choupal Saagar. ITC currently has 11 Choupal Saagars and plans to increase this number to 20 by March 2007. The company plans to set up around 100 over the next three years and 700 over the long term.

Exhibit 15

Profitability Analysis per Choupal Saagar

Total Value of Foodgrains managed in Rs mn	225
Marketing & Distribution of Products by ITC (Rs bn)	56.3
EBIT margin on foodgrain trading (%)	2.5
EBIT margin on product distribution (%)	8.0
EBIT on foodgrain sourcing & trading (Rs mn)	5.6
EBIT on product marketing and distribution (Rs mn)	4.5
Total EBIT contribution by each Choupal Saagar (Rs mn)	10.1

Source: Morgan Stanley Research estimates, based on company data

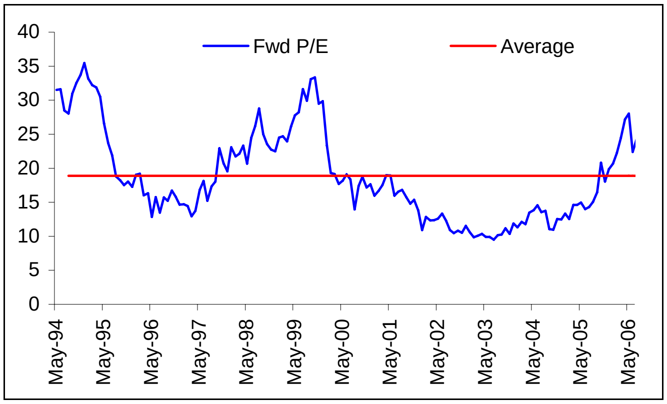
Valuation

We reiterate our Overweight rating on ITC with a price target of Rs220. Our target price for ITC is based on a 10% premium to our base case DCF valuation, given: 1. the risks to our medium-term cigarette volume growth assumptions look skewed to the upside, based on current visibility; and 2. we see upside potential from the rural distribution business that is not captured in our base case DCF valuation. Our base case DCF valuation assumes a WACC of 12.1%.

The key risks to our target price include: 1) any additional tax burden by the government in the form of VAT or a significant (over 10%) increase in excise duty; 2) inability on the company's part to turn around its food and rural distribution businesses; and 3) further regulatory pressures to curb smoking.

Exhibit 16

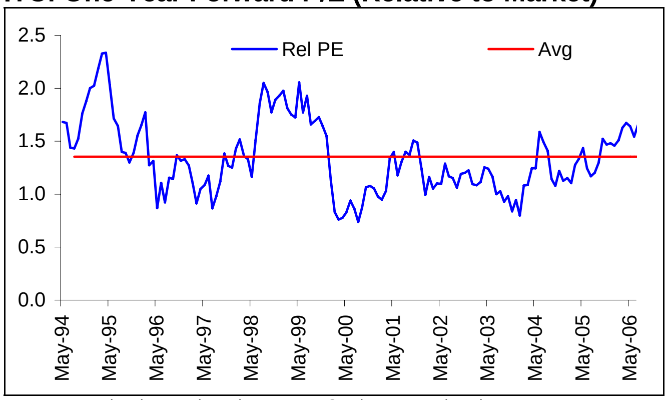
ITC: One-Year Forward P/E (Absolute)



Note: Prospective data are based on Morgan Stanley Research estimates.
Source: Company data, Morgan Stanley Research

Exhibit 17

ITC: One-Year Forward P/E (Relative to Market)



Note: Prospective data are based on Morgan Stanley Research estimates.
Source: Company data, Morgan Stanley Research

Exhibit 18

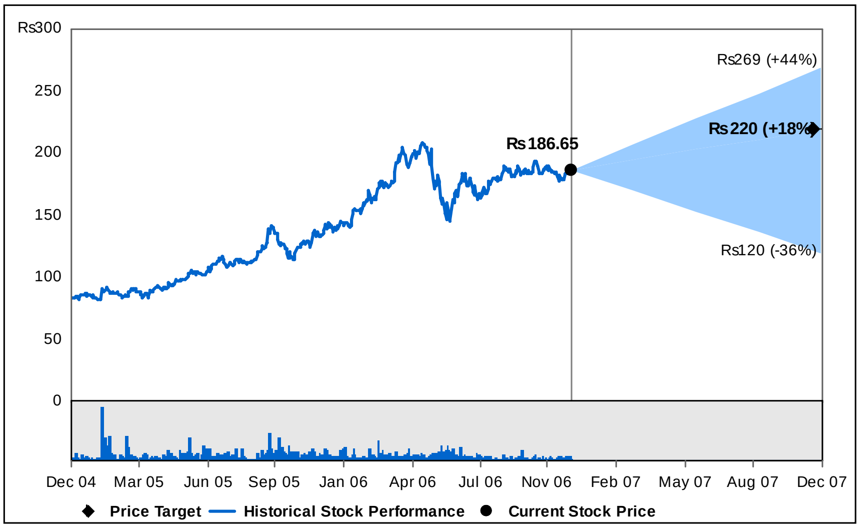
India Consumer – Comparative Valuations

	Share price, last close	Mkt Cap (US$mn)	EPS CAGR F06-09E	PER F2007E	PER F2008E	EV/EBITDA F2007E	EV/EBITDA F2008E	Div Yield F2007E	Div Yield F2008E
Hindustan Lever	240	11,856	21%	34.1	26.5	29.9	23.5	2.5%	2.9%
Colgate-Palmolive India	379	1,155	26%	26.4	21.0	20.6	17.6	2.9%	3.6%
Nestle India	1,103	2,384	15%	31.6	25.6	19.2	16.4	2.9%	3.3%
ITC Ltd.	187	15,712	17%	25.7	22.0	16.7	14.1	1.8%	2.1%
Tata Tea	755	951	9%	14.1	12.7	8.5	7.4	1.6%	1.7%
Marico	550	715	28%	23.4	18.1	14.6	12.0	2.2%	2.5%
GCPL	160	808	23%	23.3	19.6	19.2	15.6	2.2%	2.3%
Dabur India	145	1,860	20%	30.4	25.4	24.4	20.7	1.9%	2.1%

Note: For HLL and Nestle F07/08 = C06/07. Prices as of December 7, 2006
* Excludes acquisition of Glaceau, EOC and potential dilution on account of issue of warrants to Tata Sons.
E = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

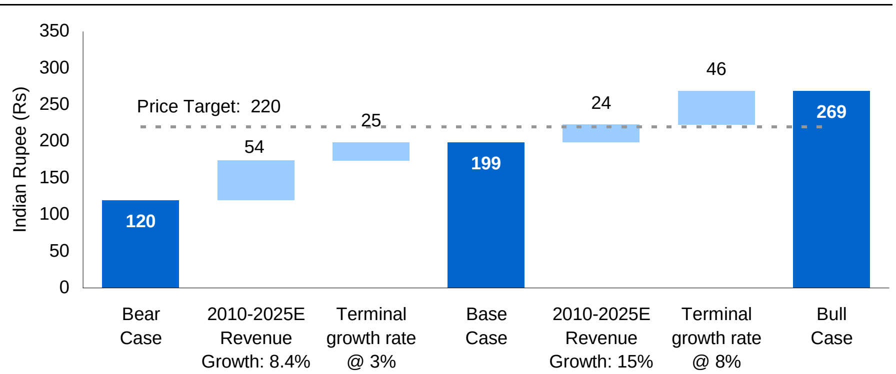
Risk-Reward Snapshot: ITC (ITC.BO, Rs187, OW, PT Rs220)

Risk-Reward View: Cigarette and Non-Tobacco FMCG to Drive Volumes



Price Target Rs220		Our price target is based on an 10% premium to our DCF value
Bull Case Rs269	32x Base Case 08e EPS	**Strong revenue growth and improved visibility on future earnings:** 15% revenue growth over F2010-25E on 10.6% growth in cigarette revenues and 19% growth in non-tobacco FMCG; terminal growth rate of 8%.
Base Case Rs199	23x Base Case 08e EPS	**Moderate revenue growth and visibility of future earnings:** 13.3% revenue growth over F2010-25E on 9.5% growth in cigarette revenues and 17% growth in non-tobacco FMCG; terminal growth rate of 6.5%.
Bear Case Rs120	14x Base Case 08e EPS	**Limited revenue growth and poor visibility on future earnings:** 8.4% revenue growth over F2010-25E on 5% growth in cigarette revenues and non-tobacco FMCG; terminal growth rate of 3%.

Bear to Bull: Equity Risk Premium; Big Stock Driver



Source: FactSet, Morgan Stanley, Research estimates

Investment Thesis

- All of ITC's existing businesses continue to perform well. Its cigarette business is witnessing volume growth combined with an improvement in product mix, while its cyclical businesses (such as hotels and paper & packaging) are also seeing healthy improvements in profits.

Key Value Drivers

- Cigarette volume growth: Despite punitive taxes and restrictions on smoking, we think the Indian cigarette industry continues to have long-term growth potential as cigarettes constitute only 15% of tobacco consumption in the country.
- Non-tobacco FMCG businesses: We see long-term growth potential for ITC's profitable and successful foray into the packaged foods business.
- Rural distribution business: ITC's 5-10-year growth will likely be driven by its rural distribution business, in which it began investing in F2000. Visibility in the company's ability to monetize its investments will drive the stock, in our view.

Potential Catalysts

- Acceleration of cigarette volume growth.
- Rapid reduction in losses of non-tobacco FMCG business.
- Increase in dividend payout ratio.

Key Risks

- Potential additional tax burden by the government in the form of VAT.
- Inability by ITC to turn around its food and rural distribution businesses.
- Further regulatory pressures to curb smoking.

ITC: Financial Summary

Exhibit 19

Profit and Loss Statement

(Rs m, Year Ending Mar)	F2006	F2007E	F2008E	F2009E
Net sales	**97,905**	**117,871**	**141,338**	**170,367**
Raw material consumed	39,910	48,106	59,356	74,220
Manufacturing expenses	4,805	5,766	6,631	7,625
Gross Profit	53,190	63,999	75,352	88,521
Margin (%)	54%	54%	53%	52%
Total Operating costs	64,710	78,441	95,273	117,060
Operating Profit	**33,196**	**39,429**	**46,065**	**53,308**
Growth (%)	18.9%	18.8%	16.8%	15.7%
Margin (%)	33.9%	33.5%	32.6%	31.3%
Interest	119	58	56	56
Depreciation/ amortzn	3,323	3,682	4,119	4,576
Other Income	2,861	3,361	3,755	3,785
Non-recurring income	-450	0	0	0
Profit before Tax	32,164	39,050	45,645	52,460
Income Tax	9,888	11,754	13,739	15,791
ModelWare Net Profit	**22,732**	**27,302**	**31,912**	**36,676**
Growth (%)	24%	20%	17%	15%
Net Margin	23%	23%	23%	22%
ModelWare EPS	**6.1**	**7.3**	**8.5**	**9.8**

E: Morgan Stanley Research Estimates
Source: Company data, Morgan Stanley Research

Exhibit 20

Balance Sheet

(Rs m, Year Ending Mar)	F2006	F2007E	F2008E	F2009E
Share Capital	3,755	3,755	3,755	3,755
Reserves & Surplus	86,268	99,480	114,478	131,416
Shareholders' Funds	90,023	103,236	118,234	135,171
Loan Funds	1,197	1,120	1,120	1,120
Deferred tax liabilities	3,248	877	877	877
TOTAL LIABILITIES	**94,468**	**105,233**	**120,231**	**137,169**
Net Fixed Assets	43,460	47,808	51,717	56,167
Investments	7,909	7,909	7,909	7,909
Cash	35,819	42,885	52,587	63,305
Debtors	5,480	6,459	7,745	9,335
Inventory	26,363	30,087	36,543	44,900
Loans & advances	9,750	11,787	14,134	17,037
Other current assets	1,468	1,768	2,120	2,556
Current liabilities	35,781	43,470	52,523	64,040
Net Current Assets	7,280	6,631	8,018	9,787
TOTAL ASSETS	**94,468**	**105,233**	**120,231**	**137,169**

E: Morgan Stanley Research Estimates
Source: Company data, Morgan Stanley Research

Exhibit 21

Cash Flow Statement

(Rs m, Year Ending Mar)	F2006	F2007E	F2008E	F2009E
Net income reported	22,354	27,296	31,906	36,670
Depreciation	3,323	3,682	4,119	4,576
Chg in working cap	-2,782	649	-1,387	-1,768
Change in deferred tax liab	-513	-2,370	0	0
Cash flow from operations	**22,382**	**29,256**	**34,638**	**39,477**
Capital expenditure	-6,013	-8,000	-8,000	-9,000
Cash flow from investing	**-6,013**	**-8,000**	**-8,000**	**-9,000**
Equity raised	659	0	0	0
LT Debt raised	78	-78	0	0
ST debt raised	-1,334	0	0	0
Dividend (incl. tax)	-11,347	-14,113	-16,936	-19,759
Cash flow from financing	**-11,944**	**-14,191**	**-16,936**	**-19,759**
Net chg in cash	4,425	7,066	9,702	10,719

E: Morgan Stanley Research Estimates
Source: Company data, Morgan Stanley Research

Exhibit 22

Key Ratios

(Rs m, Year Ending Mar)	F2006	F2007E	F2008E	F2009E
Net sales growth (%)	28.2%	20.4%	19.9%	20.5%
EBITDA growth (%)	18.9%	18.8%	16.8%	15.7%
EBIT margin (%)	30.5%	30.3%	29.7%	28.6%
Return on Avg Equity (%)	27.0%	28.2%	28.8%	28.9%
ROE - Beg Period (%)	29.0%	30.3%	30.9%	31.0%
RNOA (%)	36.6%	39.3%	42.0%	44.8%
Sales/Total Assets (x)	1.0	1.1	1.2	1.2
Sales/Net FA (x)	2.3	2.5	2.7	3.0
Debtor turnover (days)	12.3	12.4	12.7	13.1
Inventory turnover (days)	212.1	214.2	204.9	200.3
Current ratio (x)	1.4	1.3	1.3	1.3
Working capital turnover (days)	16.4	12.7	13.2	13.8
Total debt/Equity (%)	4.9%	1.9%	1.7%	1.5%
Net debt/Equity (%)	-38%	-40%	-44%	-46%
EPS	6.1	7.3	8.5	9.8
DPS	2.6	3.3	4.0	4.7
BVPS	24.0	27.5	31.5	36.0
PE	32.2	25.7	22.0	19.1
Div Yield	1.4%	1.8%	2.1%	2.5%
P/BV	8.1	6.8	5.9	5.2
P/sales	7.5	5.9	5.0	4.1
EV/EBITDA	21.0	16.7	14.1	12.0
EV/Sales	7.1	5.6	4.6	3.7

E: Morgan Stanley Research Estimates
Source: Company data, Morgan Stanley Research

Morgan Stanley
ModelWare℠

ModelWare is Morgan Stanley's new system for helping investors and analysts to uncover value, free from the distortions and ambiguities created by accounting data. Morgan Stanley has dissected and fundamentally redefined the components of corporate valuation, giving clients more consistent definitions, more comparable data, and more flexible analytic tools. ModelWare makes investment insights easier by making value more visible.

Past inconsistencies in financial reporting made it difficult to compare performance among companies and across sectors and regions. Even within US GAAP, flexibility complicates comparisons. And accounting standards were developed to analyze historical data, not to facilitate projections. In response, Morgan Stanley analysts spent two years reviewing our entire coverage universe of company metrics. They defined more than 2,000 general and industry-specific metrics that eliminated inconsistencies stemming from regional differences, historical precedents and accounting conventions. The team applied these metrics across also all 1900+ companies we cover, and created flexible tools and services that let analysts redefine and use the data with maximum creativity. Because ModelWare provides complete transparency, users see every component of every calculation, to choose elements or recombine them as they wish.

ModelWare EPS illustrates the approach. It represents ModelWare EPS as ModelWare net income divided by average fully diluted shares outstanding. ModelWare net income sums net operating profit after tax (NOPAT), net financial income or expense (NFE) and other income or expense. ModelWare adjusts reported net income to improve comparability across companies, sectors and regions. Among these adjustments: We exclude goodwill amortization and items deemed by analysts to be "one-time" events; we capitalize operating leases where their use is significant (e.g., in transportation and retail); and we convert inventory to FIFO accounting when LIFO costing is used. For more information on these adjustments and others, as well as additional background, please see *Morgan Stanley ModelWare (ver. 1.0): A Road Map for Investors*, by Trevor Harris and team, August 2, 2004.

.

Disclosure Section

The information and opinions in this report were prepared or are disseminated by Morgan Stanley Dean Witter Asia Limited (which accepts the responsibility for its contents) and/or Morgan Stanley Dean Witter Asia (Singapore) Pte. (Registration number 199206298Z, regulated by the Monetary Authority of Singapore, which accepts the responsibility for its contents), and/or Morgan Stanley Asia (Singapore) Securities Pte Ltd (Registration number 200008434H, regulated by the Monetary Authority of Singapore, which accepts the responsibility for its contents), and/or Morgan Stanley Taiwan Limited and/or Morgan Stanley & Co International Limited, Seoul Branch, and/or Morgan Stanley Dean Witter Australia Limited (A.B.N. 67 003 734 576, holder of Australian financial services license No. 233742, which accepts responsibility for its contents), and/or JM Morgan Stanley Securities Private Limited and their affiliates (collectively, "Morgan Stanley").

Analyst Certification

The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report: Hozefa Topiwalla.

Unless otherwise stated, the individuals listed on the cover page of this report are research analysts.

Global Research Conflict Management Policy

This research has been published in accordance with our conflict management policy, which is available at www.morganstanley.com/institutional/research/conflictpolicies.

Important US Regulatory Disclosures on Subject Companies

The following analyst, strategist, or research associate (or a household member) owns securities in a company that he or she covers or recommends in this report: Hozefa Topiwalla - Godrej Consumer Products Limited (common stock), Hindustan Lever (common stock), ITC Ltd. (common stock). Morgan Stanley policy prohibits research analysts, strategists and research associates from investing in securities in their sub industry as defined by the Global Industry Classification Standard ("GICS," which was developed by and is the exclusive property of MSCI and S&P). Analysts may nevertheless own such securities to the extent acquired under a prior policy or in a merger, fund distribution or other involuntary acquisition.

As of October 31, 2006, Morgan Stanley beneficially owned 1% or more of a class of common equity securities of the following companies covered in this report: Colgate-Palmolive India, Godrej Consumer Products Limited, Hindustan Lever, ITC Ltd., Marico Limited.

As of October 31, 2006, Morgan Stanley held a net long or short position of US$1 million or more of the debt securities of the following issuers covered in this report (including where guarantor of the securities): Colgate-Palmolive India, Hindustan Lever, Nestle India.

Within the last 12 months, Morgan Stanley & Co. Incorporated has received compensation for products and services other than investment banking services from Colgate-Palmolive India, Nestle India.

Within the last 12 months, Morgan Stanley has either provided or is providing non-investment banking, securities-related services to and/or in the past has entered into an agreement to provide services or has a client relationship with the following companies covered in this report: Colgate-Palmolive India, Nestle India.

The research analysts, strategists, or research associates principally responsible for the preparation of this research report have received compensation based upon various factors, including quality of research, investor client feedback, stock picking, competitive factors, firm revenues and overall investment banking revenues.

Certain disclosures listed above are also for compliance with applicable regulations in non-US jurisdictions.

STOCK RATINGS

Different securities firms use a variety of rating terms as well as different rating systems to describe their recommendations. For example, Morgan Stanley uses a relative rating system including terms such as Overweight, Equal-weight or Underweight (see definitions below). A rating system using terms such as buy, hold and sell is not equivalent to our rating system. Investors should carefully read the definitions of all ratings used in each research report. In addition, since the research report contains more complete information concerning the analyst's views, investors should carefully read the entire research report and not infer its contents from the rating alone. In any case, ratings (or research) should not be used or relied upon as investment advice. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations.

Global Stock Ratings Distribution

(as of November 30, 2006)

For disclosure purposes only (in accordance with NASD and NYSE requirements), we include the category headings of Buy, Hold, and Sell alongside our ratings of Overweight, Equal-weight and Underweight. Morgan Stanley does not assign ratings of Buy, Hold or Sell to the stocks we cover. Overweight, Equal-weight, and Underweight are not the equivalent of buy, hold, and sell but represent recommended relative weightings (see definitions below). To satisfy regulatory requirements, we correspond Overweight, our most positive stock rating, with a buy recommendation; we correspond Equal-weight and Underweight to hold and sell recommendations, respectively.

	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**804**	**38%**	**291**	**43%**	**36%**
Equal-weight/Hold	**966**	**45%**	**302**	**44%**	**31%**
Underweight/Sell	**367**	**17%**	**90**	**13%**	**25%**
Total	**2,137**		**683**		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

Analyst Stock Ratings

Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Underweight (U or Under) - The stock's total return is expected to be below the total return of the relevant country MSCI Index, on a risk-adjusted basis, over the next 12-18 months.

More volatile (V) - We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst's view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "more volatile" can still perform in that manner.

Unless otherwise specified, the time frame for price targets included in this report is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.

Stock price charts and rating histories for companies discussed in this report are available at www.morganstanley.com/companycharts or from your local investment representative. You may also request this information by writing to Morgan Stanley at 1585 Broadway, (Attention: Equity Research Management), New York, NY, 10036 USA.

Other Important Disclosures

For a discussion, if applicable, of the valuation methods used to determine the price targets included in this summary and the risks related to achieving these targets, please refer to the latest relevant published research on these stocks. Research is available through your sales representative or on Client Link at www.morganstanley.com and other electronic systems.

This report does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The securities discussed in this report may not be suitable for all investors. Morgan Stanley recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a financial adviser. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. The securities, instruments, or strategies discussed in this report may not be suitable for all investors, and certain investors may not be eligible to purchase or participate in some or all of them.

This report is not an offer to buy or sell or the solicitation of an offer to buy or sell any security or to participate in any particular trading strategy. The "Important US Regulatory Disclosures on Subject Companies" section lists all companies mentioned in this report where Morgan Stanley owns 1% or more of a class of common securities of the companies. For all other companies mentioned in this report, Morgan Stanley may have an investment of less than 1% in securities or derivatives of securities of companies mentioned in this report, and may trade them in ways different from those discussed in this report. Employees of Morgan Stanley not involved in the preparation of this report may have investments in securities or derivatives of securities of companies mentioned in this report, and may trade them in ways different from those discussed in this report. Derivatives may be issued by Morgan Stanley or associated persons.

Morgan Stanley and its affiliate companies do business that relates to companies covered in its research reports, including market making and specialized trading, risk arbitrage and other proprietary trading, fund management, commercial banking, extension of credit, investment services and investment banking. Morgan Stanley sells to and buys from customers the securities/instruments of companies covered in its research reports on a principal basis.

With the exception of information regarding Morgan Stanley, reports prepared by Morgan Stanley research personnel are based on public information. Morgan Stanley makes every effort to use reliable, comprehensive information, but we make no representation that it is accurate or complete. We have no obligation to tell you when opinions or information in this report change apart from when we intend to discontinue research coverage of a subject company. Facts and views presented in this report have not been reviewed by, and may not reflect information known to, professionals in other Morgan Stanley business areas, including investment banking personnel.

Morgan Stanley research personnel conduct site visits from time to time but are prohibited from accepting payment or reimbursement by the company of travel expenses for such visits.

The value of and income from your investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. There may be time limitations on the exercise of options or other rights in your securities transactions. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized. Unless otherwise stated, the cover page provides the closing price on the primary exchange for the subject company's securities.

To our readers in Taiwan: Information on securities that trade in Taiwan is distributed by Morgan Stanley Taiwan Limited ("MSTL"). Such information is for your reference only. The reader should independently evaluate the investment risks and is solely responsible for their investment decisions. This publication may not be distributed to the public media or quoted or used by the public media without the express written consent of Morgan Stanley. Information on securities that do not trade in Taiwan is for informational purposes only and is not to be construed as a recommendation or a solicitation to trade in such securities. MSTL may not execute transactions for clients in these securities.

To our readers in Hong Kong: Information is distributed in Hong Kong by and on behalf of, and is attributable to, Morgan Stanley Dean Witter Asia Limited as part of its regulated activities in Hong Kong. If you have any queries concerning this publication, please contact our Hong Kong sales representatives.

Certain information in this report was sourced by employees of the Shanghai Representative Office of Morgan Stanley Dean Witter Asia Limited for the use of Morgan Stanley Dean Witter Asia Limited.

This publication is disseminated in Japan by Morgan Stanley Japan Securities Co., Ltd.; in Hong Kong by Morgan Stanley Dean Witter Asia Limited (which accepts responsibility for its contents); in Singapore by Morgan Stanley Dean Witter Asia (Singapore) Pte. (Registration number 199206298Z) and/or Morgan Stanley Asia (Singapore) Securities Pte Ltd (Registration number 200008434H), regulated by the Monetary Authority of Singapore, which accepts responsibility for its contents; in Australia by Morgan Stanley Dean Witter Australia Limited A.B.N. 67 003 734 576, holder of Australian financial services licence No. 233742, which accepts responsibility for its contents; in Korea by Morgan Stanley & Co International Limited, Seoul Branch; in India by JM Morgan Stanley Securities Private Limited; in Canada by Morgan Stanley Canada Limited, which has approved of, and has agreed to take responsibility for, the contents of this publication in Canada; in Germany by Morgan Stanley Bank AG, Frankfurt am Main, regulated by Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin); in Spain by Morgan Stanley, S.V., S.A., a Morgan Stanley group company, which is supervised by the Spanish Securities Markets Commission (CNMV) and states that this document has been written and distributed in accordance with the rules of conduct applicable to financial research as established under Spanish regulations; in the United States by Morgan Stanley & Co. Incorporated and Morgan Stanley DW Inc., which accept responsibility for its contents. Morgan Stanley & Co. International Limited, authorized and regulated by Financial Services Authority, disseminates in the UK research that it has prepared, and approves solely for the purposes of section 21 of the Financial Services and Markets Act 2000, research which has been prepared by any of its affiliates. Private U.K. investors should obtain the advice of their Morgan Stanley & Co. International Limited representative about the investments concerned. In Australia, this report, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

The trademarks and service marks contained herein are the property of their respective owners. Third-party data providers make no warranties or representations of any kind relating to the accuracy, completeness, or timeliness of the data they provide and shall not have liability for any damages of any kind relating to such data. The Global Industry Classification Standard ("GICS") was developed by and is the exclusive property of MSCI and S&P.

Morgan Stanley has based its projections, opinions, forecasts and trading strategies regarding the MSCI Country Index Series solely on publicly available information. MSCI has not reviewed, approved or endorsed the projections, opinions, forecasts and trading strategies contained herein. Morgan Stanley has no influence on or control over MSCI's index compilation decisions.

Morgan Stanley research is disseminated and available primarily electronically, and, in some cases, in printed form.

Additional information on recommended securities is available on request.

Morgan Stanley

JM MORGAN STANLEY

MORGAN STANLEY RESEARCH

The Americas
1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1) 212 761 4000

Europe
25 Cabot Square, Canary Wharf
London E14 4QA
United Kingdom
Tel: +44 (0) 20 7 425 8000

Japan
4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008
Japan
Tel: +81 (0) 3 5424 5000

Asia/Pacific
Three Exchange Square
Central
Hong Kong
Tel: +852 2848 5200

Industry Coverage:India Consumer

Company (Ticker)	Rating (as of)	Price (12/07/2006)
Hozefa Topiwalla		
Colgate-Palmolive India (COLG.BO)	O (01/10/2005)	Rs378.75
Dabur India (DABU.BO)	O (10/18/2006)	Rs144.75
Godrej Consumer Products Limited (GOCP.BO)	O (07/24/2006)	Rs159.65
Hindustan Lever (HLL.BO)	O (08/01/2005)	Rs240.35
ITC Ltd. (ITC.BO)	O (12/07/2006)	Rs186.65
Marico Limited (MRCO.BO)	O (03/07/2006)	Rs549.95
Nestle India (NEST.BO)	O (05/02/2002)	Rs1103.30
Tata Tea (TTTE.BO)	E (09/04/2006)	Rs754.80

Stock Ratings are subject to change. Please see latest research for each company.