ITC Ltd - BUY

CMP Rs175, Target Rs216

Sector: FMCG	
Sensex:	9,471
CMP (Rs):	175
Target price (Rs):	216
Upside (%):	23.2
52 Week h/l (Rs):	232 / 132
Market cap (Rscr) :	66,102
6m Avg vol ('000Nos):	6,159
No of o/s shares (mn):	3,774
FV (Re):	1
Bloomberg code:	ITC IB
Reuters code:	ITC.BO
BSE code:	500875
NSE code:	ITC

Prices as on 24 Mar, 2009.

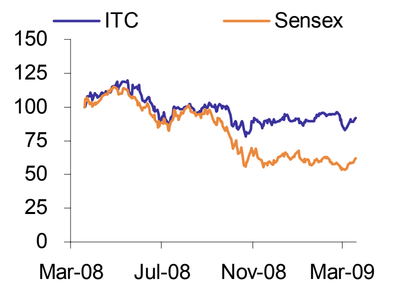
Shareholding pattern

December '08	(%)
Institutions	85.0
Non promoter corp hold	2.9
Public & others	12.1

Performance rel. to sensex

(%)	1m	3m	1yr
ITC	(10.5)	2.5	30.9
HUL	(12.8)	(6.2)	40.5
Britannia	(5.9)	9.5	45.8
Nestle	(4.6)	9.6	46.6

Share price trend



Strong resilience in cigarette volumes

ITC has managed to register stable earnings growth with a marginal decline in volumes despite heavy tax burden and regulatory restrictions on cigarettes. With its strong brand recognition and product portfolio, ITC has always been well-placed to pass on any tax burden to consumers. The pictorial warnings and smoking ban are not likely to have a major impact on the segment due to implementation issues.

Major beneficiary from shift in demand to filter cigarettes

The Government has levied additional excise duty on the non-filter cigarettes mainly to bring them on par with filter cigarettes. ITC exited from it post excise hike as it had a very small presence. The demand uptrade from non-filter to filter and premium filter cigarettes (post excise duty hike) is expected to be almost over 75%. ITC being the market leader in the filter cigarettes category will be the major beneficiary from this shift in demand. We expect cigarette revenues to increase by ~9% yoy during FY09 despite a decline of ~3% in volumes as a result of the full impact of price hikes and improved realizations on account of favourable product mix.

Diversified into various lucrative segments

ITC over the years has been investing cash flows from its cigarette business into various lucrative segments like foods, personal care, hotels and paper. With the paperboard division coming out of a major capex cycle and a reduction in losses from FMCG-others division from FY10E, we expect the non-cigarette businesses to become self-sufficient. The agri division continues to provide a strong support as an excellent raw material sourcing base. Hotels segment though is likely to register slower growth in FY10E due to economic slowdown and terror attacks.

Expect to witness 17% PAT CAGR over FY09-11

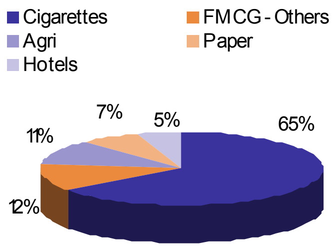
ITC remains one of our top pick in the sector given the strong resilience in its core cigarette business. We expect ITC to register 17% CAGR in net profit over FY09-11. At the current market price of Rs175, the stock is trading at 14.4x FY11E EPS of Rs12.1. We recommend BUY with a price target of Rs216, an upside of 23.2%.

Valuation summary

Y/e 31 Mar (Rs m)	FY08	FY09E	FY10E	FY11E
Revenues	139,475	161,772	188,902	219,501
yoy growth (%)	14.7	16.0	16.8	16.2
Operating profit	44,039	48,645	57,332	67,694
OPM (%)	31.6	30.1	30.4	30.8
Reported PAT	31,201	33,413	39,037	45,704
yoy growth (%)	15.6	7.1	16.8	17.1
EPS (Rs)	8.3	8.9	10.4	12.1
P/E (x)	21.2	19.8	16.9	14.4
Price/Book (x)	5.5	4.8	4.2	3.7
EV/EBITDA (x)	14.9	13.5	11.5	9.7
Debt/Equity (x)	0.0	0.0	0.0	0.0
RoE (%)	27.7	26.0	26.7	27.4
RoCE (%)	38.3	36.4	37.7	38.8

Source: Company, India Infoline Research

ITC's gross revenue mix – FY08



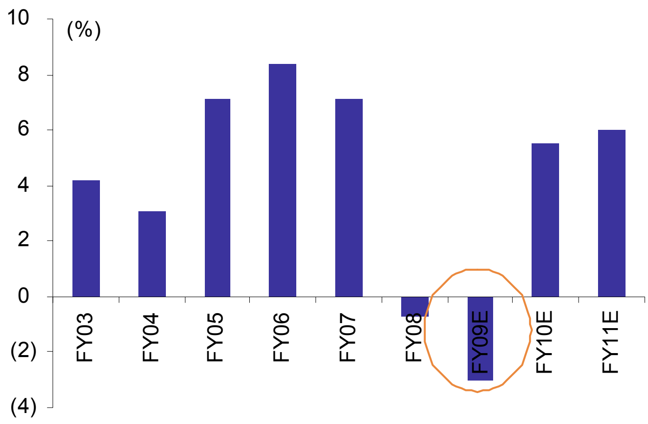
Source: Company, India Infoline Research

Strong resilience in cigarette volumes

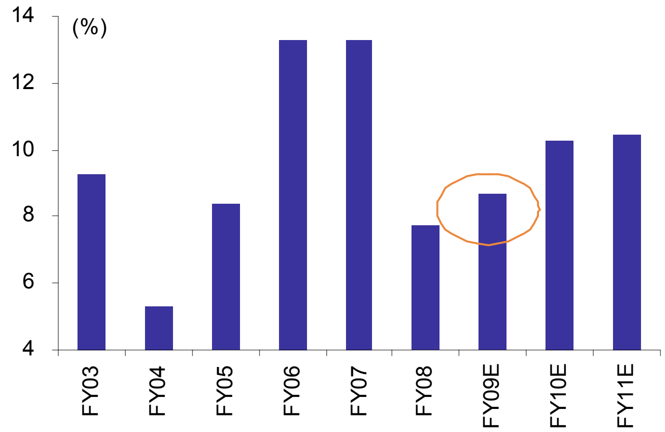
Despite heavy tax burden and regulatory restrictions on the cigarette segment, ITC has maintained a stable earnings growth with a marginal decline in volumes, reflecting its pricing power. ITC, with a market share of 84%, coupled with strong product portfolio and brand recognition, has always been well-placed to pass on any tax burden to consumers. Cigarette demand is inelastic in nature and this business continues to be a cash cow for the company.

Post the duty hikes announced in the previous two budgets, we don't expect any substantial duty/tax hike to be levied on cigarettes in the near future. ITC has exited completely from the non-filter cigarette segment since the Government has levied additional excise duty. It has launched some new variants at lower price points to fill in the gap. We expect ITC to witness a marginal ~3% decline in cigarette volumes (as a result of exit from non-filter segment and initial impact of the smoking ban) during FY09. The cigarette segment volume growth is likely to be back on track to ~6% in FY10.

Cigarette volume growth



Cigarette value growth



Source: Company, India Infoline Research

Major beneficiary from excise levy on non-filter cigarettes

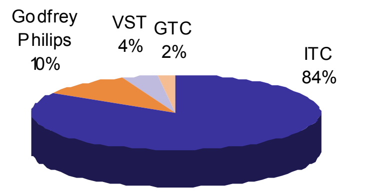
In the 2008-09 budget, the Government increased excise duty on non-filter plains and micros (cigarettes) to Rs1,323 and Rs819 per 1,000 sticks, respectively while, excise duty on filter cigarettes was kept unchanged. The move was mainly to bring non-filter cigarettes on par with filter cigarettes of similar length.

Excise duty structure on non-filter cigarettes

(Rs per '000 sticks)	Old	New	% increase
Filter			
>85mm	2,163	2,163	-
75-85mm	1,759	1,759	-
70-75mm	1,323	1,323	-
<70mm	819	819	-
Non-filter			
60-70mm	546	1,323	142.3
<60mm	168	819	387.5
Biris			
Non-machine made	11	11	-
Machine made	24	24	-

Source: Budget documents, India Infoline Research

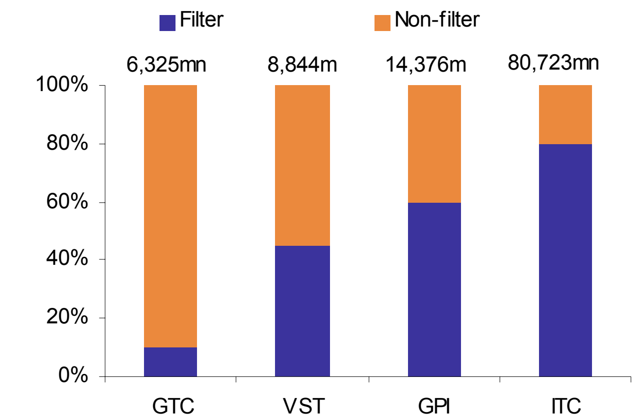
Value market shares – FY08



Source: Company, India Infoline Research

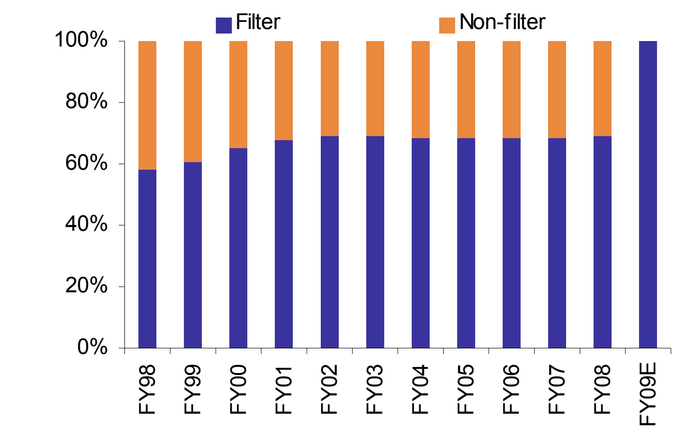
Micro and plain cigarettes accounted for a small portion of ITC's portfolio (20% of volumes, 10% of revenues and ~8% of profits). Post excise hike on the non-filter cigarettes, ITC has stopped production as it was unviable. Other players like VST Industries, GTC have also started shifting their focus to filter cigarettes. However, we don't believe this to have any major impact on ITC. Competitors need to scale up and build capabilities thereby giving ITC a clear advantage. The demand uptrade from non-filter to filter and premium filter cigarettes (post excise duty hike) is expected to be almost over 75%. We estimate the filterisation of the cigarette portfolio to fuel ITC's cigarette segment's EBIT margins by ~110bps in FY09.

Filter vs non-filter breakdown – FY08



Source: Companies, India Infoline Research

Cigarettes volume mix of ITC



Source: Company, India Infoline Research

Implementation of directive of printing on pictorial warnings on cigarette and biri packs postponed till May 31, 2009.

Pictorial warnings & smoking ban - no major impact likely

The Government has passed the Cigarettes and Other Tobacco Products Act, (Cotpa) in 2003, which is applicable to all forms of tobacco - cigarettes, biris, chewing tobacco, etc. The Act includes a ban on smoking in public places, direct and indirect bans on cigarette advertisements, restrictions on the sale of tobacco to minors or within 100 yards of any educational institution, mandatory pictorial warnings on tobacco products, etc.

The Government has passed a directive to print pictorial warnings on cigarette and biri packs, which is likely to be implemented from May 31, 2009 after many delays (as it was originally scheduled for February 2007 and then was postponed to November 2008). The Act had initially prescribed printing on intense pictures like cancer-struck body parts (required to cover 30-45% of the package surface area) which were later revised to scorpions, skull and bones and damaged lungs. ITC is well equipped to enforce this packaging change. We don't expect these pictorial warnings to have a significant impact on cigarette consumption in India as almost 70% cigarettes are sold in the loose form most of the consumers won't be able to see warnings shown on the packs.

Pictorial warnings to be printed on the packs

Source: Health Ministry, India Infoline Research

Smoking ban in public places effective from October 02, 2008.

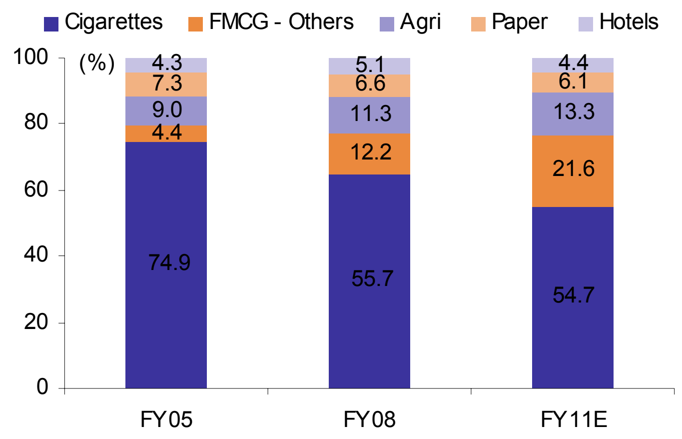
The ban on smoking in public places including private offices, bars and restaurants took effect from October 02, 2008. However, implementation of such a ban at the local level is a very tough task, given the stretched resources of the law-enforcing agencies in India. We believe this ban will not have a major impact given the many implementation issues. The impact of the ban is expected to be restricted to cigarette consumption in bars and restaurants and that too especially in the metro cities only, where enforcement would be better.

Business mix continues to evolve

Contribution of cigarette segments to total gross revenues to come down to ~55% by FY11.

Instead of paying out huge dividends, ITC has started investing cash flows from its cigarette business into various lucrative segments such as foods, personal care and long-gestation businesses like hotels and paper. As a result, contribution of the cigarette business to total gross revenues is expected to come down from ~75% in FY05 to ~55% by FY11. Meanwhile, with the rapid capacity expansion across segments, contribution of non-cigarettes businesses is expected to increase sharply going forward.

Changing revenue mix



Source: Company, India Infoline Research

Other FMCG business - losses to reduce post FY10

The FMCG-others segment comprises of packaged foods, branded garments, greeting, gifting & stationery, agarbattis, safety matches and personal care business. This segment has witnessed a healthy CAGR of ~64% in revenue over FY05-08 and can now be counted among the top five Indian consumer goods businesses. ITC's two key brands - Aashirvaad (branded staples) and Sunfeast (biscuits, 12% market share) - have crossed Rs10bn each in retail sales during FY08.

After making its mark in the foods segment, ITC entered into the very competitive personal care market through launch of perfumes, shampoos/conditioners, shower gels and toilet soaps in September 2007. We believe ITC is unlikely to enter into a price war to gain market share as most of its products are priced at similar price points as those of Hindustan Unilever and Procter & Gamble.

The management has indicated that the soaps/shampoos (achieved market share of ~2.5%) roll out is in line with internal targets and there is no plan to enter the oral care category.

Product portfolio break-up of FMCG-others segment

Segment	Brands
Branded packaged foods	Aashirvaad (atta, salt, spices), Sunfeast (biscuits & pasta), Bingo (snacks), Mint-o & Candyman (confectionery), Kitchens of India (ready to eat, conserves & chutney and frozen foods), Aashirvaad (instant mixes & cooking pastes)
Lifestyle retailing	Wills Lifestyle (premium), John Players (mid-end), Miss Players
Personal-care segment	Essenza Di Wills (super premium - fragrance and personal care), Fiama Di Wills (premium - shampoos, soaps, shower gels and conditioners), Vivel Di Wills and Vivel (mid – soaps and shampoos), Superia (a mass-market range of shampoos and soaps)
Education & stationery	Expressions (greeting cards), Paperkraft and Classmate (notebooks & stationery)
Safety Matches	Aim, Mangaldeep, i Kno, Aim Mega, Aim Metro, Wimco Brands (Ship, Homelites, Cheetah Fight etc.)
Agarbattis	Mangaldeep, Expressions Aromatic Candles

Source: Company, India Infoline Research

FMCG-others segment's losses to be contained at ~Rs4.9bn in FY09.

This FMCG-others segment however, continues to incur losses mainly on account of heavy spends on advertising and promotion in foods and personal care business. With the quarterly losses stabilizing at around Rs1bn, we believe losses to be contained at ~Rs4.9bn during FY09. Excluding Bingo and personal care segment, this division is likely to turn profitable in FY10 and start contributing positively to the bottom line. We expect the losses to start reducing from FY10 onwards (Rs1.6bn in FY11) as the foods business will turn around (Aashirvaad and Sunfeast likely to breakeven at PBT level) and spends on personal care business reduce significantly.

Agri business: an excellent sourcing base

ITC had started this division with an objective of backward integration to supply raw tobacco to its cigarette division. ITC dominates the leaf tobacco and wheat exports segment and is the second largest procurer of soya in India. The company uses ~60% of the procured leaf tobacco for its captive consumption, while the entire wheat procured is used by its bakery and staples business. This business provides ITC an excellent sourcing base for its non-cigarette business as well. With the acquisition of Technico of Australia, ITC has also forayed into procurement of chipstock potatoes, one of the critical raw materials in the manufacture of Bingo products.

Agri segment to witness revenue CAGR of ~21% over FY09-11.

With efficient backward linkage with farmers, developed through a unique procurement system (e-Choupal), ITC has emerged as a preferred supplier for global giants like Cargill, Marubeni and Toepfer. ITC has extended its e-Choupal network used for sourcing agri products to ~6,400 kiosks and has set up 23 Choupal Saagars, which are operational in three states. It has also set up three Choupal Fresh Cash & Carry stores and six Choupal Fresh retail stores (in Hyderabad, Pune and Chandigarh) for retailing of fruits and vegetables. We expect the agri business to witness a CAGR of ~21% in revenue over FY09-11.

Hotels segment to witness slower growth due to economic slowdown

Emerged as a second largest hotel chain in India together with Welcomgroup.

ITC entered the hotels segment in 1975 and has emerged as the second largest hotel chain in India together with Welcomgroup. ITC has a capacity of over 6,000 rooms including ~2,900 5-star rooms. With 90 properties spread across 77 locations, ITC operates hotels under four distinct brands - ITC Hotels, Welcome Hotel, Fortune and Welcome Heritage, in addition to four properties carrying the Sheraton franchise. The company also has an exclusive tie-up with Starwood, in which seven of ITC's properties are associated with its Luxury collection franchise.

ITC's hotel segments

Segment	Starwood's Luxury collection	Sheraton collection	Welcomheritage	Fortune Park
Segment	5-star deluxe	5-star	Located at places of cultural interest	Budget
Arrangement	Owned by ITC	Owned by ITC	50% JV	100% subsidiary of ITC
Properties	7 owned, 1 managed, 2 upcoming	2 owned	52	24
Rooms	2188	719	NA	More than 1,700

Source: Company, India Infoline Research

ITC plans to invest ~Rs10bn in its hotels business in the next three years. The Bangalore property (300 rooms) is scheduled to be launched in Q1 FY10 while the Chennai property (600 rooms) is likely to commence operations by mid-FY11. Delay in most of the capacity expected to come up in Delhi before the Commonwealth Games scheduled in 2011, augurs well for ITC as it will translate into better occupancies and ARRs for ITC's properties in Delhi. However, the economic slowdown and the terror attacks (in November 2008 in Mumbai) have impacted hotel industry and resulted in a drop in ARRs (average room rates) as well as Occupancy rates. We expect the hotel segment to witness revenue CAGR of 10.4% over FY09-11 (lower than the 24% CAGR witnessed over FY05-08).

Paper business expansion remains on track

In 1979, ITC diversified into paperboard business, which is an important packaging material for cigarettes and has now become one of the leading players in the paperboards and specialty-papers business in India. Like agri segment, this segment is also used for the backward integration of many of ITC's businesses such as personal care and cigarettes, ensuring security of supplies and sustaining high quality at competitive prices. ITC has two brands - Classmate and Paperkraft and sells notebooks, copier and printer paper, writing instruments and scholastic products under these brands.

The paper business expansion and performance remains on track. We expect revenue growth to remain strong at over 15% led by ramp up in production of the newly commissioned plants (100,000tpa paper plant and pulp plant) coupled with strong underlying demand from areas such as specialty packaging. However, EBIT margins are expected to decline by 150bps in FY09 due to inflation in cost of major raw materials and higher depreciation on account of investment in new pulp and paper machines. Margins are expected to start recovering from FY10. We expect the segment to witness revenue CAGR of 11.3% over FY09-11.

Will maintain healthy dividend payout of ~50%.

Capex of ~Rs60bn over FY09-11; dividend payout to be maintained

ITC's capital expenditure over the past three years increased sharply due to higher spending on the paperboard and cigarette segments, which accounted for over 60% of total capex. The ~Rs21bn of additional capex in FY08 was the highest capex by ITC in a single year. The company has planned a capex of ~Rs60bn over FY09-11, which will be funded through internal accruals. We expect capex to be spread out almost equally over the three years. Despite the major capex incurred in FY08 and likely capex of ~Rs20bn in FY09, we expect ITC to maintain its dividend payout ratio at ~50%.

Expect 16% revenue CAGR and 17% PAT CAGR over FY09-11

ITC has shown strong resilience in cigarette segment even with a sharp rise in excise and tax burden. We expect cigarette revenues to increase by ~9% yoy despite a decline of ~3% in volumes during FY09. We expect ITC to register 17% CAGR in net profit over FY09-11. At the current market price of Rs175, the stock is trading at 14.4x FY11E EPS of Rs12.1. ITC remains one of our top picks in the sector. We recommend BUY with a one-year price target of Rs216, an upside of 23.2%.

Concerns

- Cigarette segment faces regulatory risks. Any additional tax or excise burden could dampen revenue growth.

- Lower than expected profitability in hotel business due to the adverse macro environment and post-terror effect can affect our estimates.

- Hotels and paper are prone to cyclical risks, and scaling up of the non-cigarette FMCG business faces execution risk.

- Operating margins are expected to witness marginal expansion in FY10 and FY11 due to firm input prices and rising revenue contribution of the low-margin businesses.

- Entry of foreign players and rising competition from existing domestic players could increase competition in the core cigarettes segment.

Financials

Income statement

Y/e 31 Mar(Rs m)	FY08	FY09E	FY10E	FY11E
Revenue	139,475	161,772	188,902	219,501
Operating profit	**44,039**	**48,645**	**57,332**	**67,694**
Depreciation	(4,385)	(5,422)	(6,101)	(6,916)
Interest expense	(46)	(52)	(47)	(47)
Other income	6,109	6,329	6,649	6,979
Profit before tax	**45,718**	**49,500**	**57,833**	**67,710**
Taxes	(14,517)	(16,088)	(18,796)	(22,006)
Net profit	**31,201**	**33,413**	**39,037**	**45,704**

Balance sheet

Y/e 31 Mar (Rs m)	FY08	FY09E	FY10E	FY11E
Equity capital	3,769	3,770	3,770	3,770
Reserves	116,808	132,576	151,763	174,309
Net worth	**120,577**	**136,346**	**155,533**	**178,079**
Debt	2,144	2,244	2,344	2,444
Def. tax liab (net)	5,451	5,451	5,451	5,451
Total liabilities	**128,172**	**144,041**	**163,328**	**185,974**
Fixed assets	72,957	86,802	99,199	111,943
Investments	29,346	28,354	30,408	32,962
Net working cap	**20,167**	**23,725**	**28,230**	**33,749**
Inventories	40,505	47,424	55,894	65,549
Sundry debtors	7,369	8,598	10,092	11,787
Cash	16,616	17,891	19,111	20,491
Other curr. assets	(27,414)	(31,778)	(37,108)	(43,118)
Sundry creditors	(16,910)	(18,410)	(19,760)	(20,960)
Other curr. liab.	5,703	5,160	5,492	7,320
Total assets	**128,172**	**144,041**	**163,328**	**185,974**

Cash flow statement

Y/e 31 Mar (Rs m)	FY08	FY09E	FY10E	FY11E
Profit before tax	45,718	49,500	57,833	67,710
Depreciation	4,385	5,422	6,101	6,916
Tax paid	(14,517)	(16,088)	(18,796)	(22,006)
Working capital ∆	(4,847)	(3,558)	(4,505)	(5,519)
Operating cashflow	30,738	35,277	40,633	47,101
Capital expenditure	(21,232)	(19,267)	(18,498)	(19,660)
Free cash flow	**9,506**	**16,009**	**22,135**	**27,441**
Equity raised	437	2	-	-
Investments	1,332	992	(2,054)	(2,554)
Debt financing/ disposal	136	100	100	100
Dividends paid	(15,432)	(17,645)	(19,850)	(23,158)
Other items	722	-	-	-
Net ∆ in cash	**(3,299)**	**(542)**	**331**	**1,828**

Key ratios

Y/e 31 Mar	FY08	FY09E	FY10E	FY11E
Growth matrix (%)				
Revenue growth	14.7	16.0	16.8	16.2
Op profit growth	11.3	10.5	17.9	18.1
EBIT growth	16.4	8.3	16.8	17.1
Net profit growth	15.6	7.1	16.8	17.1
Profitability ratios (%)				
OPM	31.6	30.1	30.4	30.8
EBIT margin	32.8	30.6	30.6	30.9
Net profit margin	22.4	20.7	20.7	20.8
RoCE	38.3	36.4	37.7	38.8
RoNW	27.7	26.0	26.7	27.4
RoA	19.4	18.2	18.8	19.4
Per share ratios				
EPS	8.3	8.9	10.4	12.1
Dividend per share	3.5	4.0	4.5	5.3
Cash EPS	9.4	10.3	12.0	14.0
Book value per share	32.0	36.2	41.3	47.2
Payout (%)				
Dividend payout	49.5	52.8	50.8	50.7
Tax payout	31.8	32.5	32.5	32.5
Liquidity ratios				
Debtor days	19	19	20	20
Inventory days	106	107	108	109
Creditor days	72	72	72	72
Leverage ratios				
Interest coverage	992.7	952.9	1,231.5	1,441.6
Net debt / equity	(0.03)	(0.02)	(0.02)	(0.03)
Net debt / op. profit	(0.1)	(0.1)	(0.1)	(0.1)
Component ratios (%)				
Raw material	43.1	43.5	43.2	42.8
Staff cost	5.3	5.5	5.4	5.4
Advertising	3.1	3.8	3.8	3.8
Other operating exp	17.0	17.2	17.3	17.2

Du-Pont Analysis

Y/e 31 Mar	FY08	FY09E	FY10E	FY11E
Tax burden (x)	0.68	0.68	0.68	0.68
Interest burden (x)	1.00	1.00	1.00	1.00
EBIT margin (x)	0.33	0.31	0.31	0.31
Asset turnover (x)	0.87	0.88	0.91	0.93
Financial leverage (x)	1.43	1.43	1.42	1.41
RoE (%)	**27.7**	**26.0**	**26.7**	**27.4**

Recommendation parameters for fundamental reports:

Buy – Absolute return of over +10%

Market Performer – Absolute return between -10% to +10%

Sell – Absolute return below -10%

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