Motilal Oswal

ITC

STOCK INFO.	BLOOMBERG
BSE Sensex: 9,330	ITC IN
	REUTERS CODE
S&P CNX: 2,846	ITC.BO

19 January 2009

Buy

Previous Recommendation:Buy

Rs171

Equity Shares (m)	3,762.2
52-Week Range	232/132
1,6,12 Rel. Perf. (%)	3/28/31
M.Cap. (Rs b)	641.6
M.Cap. (US$ b)	13.2

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
03/07A	121,643	27,000	7.2	13.2	23.8	6.1	25.9	35.4	5.0	15.2
03/08A	139,475	31,201	8.3	15.6	20.6	5.3	25.9	35.8	4.4	13.8
03/09E	159,026	32,748	8.7	5.0	19.6	4.7	23.9	33.7	3.7	12.4
03/10E	180,658	38,264	10.2	16.8	16.8	4.1	24.3	34.7	3.2	10.7

- ITC's 3QFY09 results are below estimates. PAT at Rs9b (est Rs9.5b) was up 8.7%. Net sales at Rs38b were up 11% YoY (est of Rs41.5b). EBIDTA at Rs13.5b increased 12.8% (v/s est of Rs13.8b); EBIDTA margin at 35.3% has expanded by 60bp (est decline of 150bp) due to 50bp decline in other expenditure.
- Cigarette volumes declined 3.5% (3% in 9MFY09) due to higher base effect in 3QFY08. Net sales grew 17.7%, PBIT grew 18% as PBIT margins expanded 10bp. Margin expansion reflected full impact of 10% price increase in Gold Flake brand. We are increasing FY09 cigarette volume decline estimate to 3% from 2%.
- New FMCG businesses sales grew 11% to Rs7.2b (5% decline QoQ), while PBIT losses increased 97% to Rs1.27b (Rs1.16b in 2QFY09). ITC has attributed lower sales growth to defocus on low margin products and impact of slowdown on lifestyle retailing and impulse fast foods.
- Hotel business reported 14% decline in sales and 34% decline in PBIT as margin declined 10.25%. Occupancy levels have declined from peak of 75-80% to 60%, while ARRs are down 5-6%. Agri business reported 6% decline in sales to Rs6.2b due to lower volumes of soya. However, higher realization in leaf tobacco exports enabled the division to report margin expansion of 350bp.
- ITC's focus seems to be shifting from topline growth to profitability. We believe cigarette and paper segments will continue to be key profit drivers in the near term. Hotels and new FMCG will continue to remain under pressure. We are cutting earnings estimates to factor in higher losses in new FMCG and profit decline in hotel business. Our revised estimates for FY09 and FY10 are Rs8.7 (v/s Rs9) and Rs10.2 (v/s Rs10.4) respectively. The stock trades at 19.6x FY09E EPS of Rs8.7 and 16.8x FY10E EPS of Rs10.2. Maintain **Buy.**

QUARTERLY PERFORMANCE

Y/E MARCH	FY08				FY09				FY08	FY09E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Net Sales	**33,252**	**32,734**	**34,580**	**39,344**	**38,997**	**37,633**	**38,333**	**44,063**	**139,475**	**159,026**
YoY Change (%)	*16.7*	*13.4*	*11.0*	*13.5*	*17.3*	*15.0*	*10.9*	*12.0*	*14.7*	*14.0*
Total Exp	21,977	22,414	22,583	28,897	27,726	26,473	24,806	32,072	95,436	111,077
EBITDA	**11,276**	**10,320**	**11,997**	**10,447**	**11,271**	**11,160**	**13,527**	**11,992**	**44,039**	**47,950**
Margins (%)	*33.9*	*31.5*	*34.7*	*26.6*	*28.9*	*29.7*	*35.3*	*27.2*	*31.6*	*30.2*
Depreciation	1,010	1,062	1,097	1,215	1,261	1,340	1,442	1,443	4,385	5,486
Interest	-8	9	18	27	14	28	5	54	46	100
Other Income	1,016	2,083	1,374	1,637	1,144	2,098	1,229	1,325	6,109	5,795
PBT	**11,289**	**11,331**	**12,256**	**10,842**	**11,140**	**11,890**	**13,310**	**11,819**	**45,718**	**48,159**
Tax	3,461	3,623	3,948	3,485	3,653	3,864	4,277	3,617	14,517	15,411
Rate (%)	*30.7*	*32.0*	*32.2*	*32.1*	*32.8*	*32.5*	*32.1*	*30.6*	*31.8*	*32.0*
Reported PAT	**7,829**	**7,709**	**8,307**	**7,357**	**7,487**	**8,027**	**9,032**	**8,202**	**31,201**	**32,748**
YoY Change (%)	20.0	13.4	15.8	13.1	-4.4	4.1	8.7	11.5	*15.4*	5.0
Adjusted PAT	**7,829**	**7,709**	**8,307**	**7,357**	**7,487**	**8,027**	**9,032**	**8,202**	**31,201**	**32,748**
YoY Change (%)	*20.0*	*13.4*	*15.8*	*13.1*	*-4.4*	*4.1*	*8.7*	*11.5*	*15.6*	*5.0*

E: MOSt Estimates

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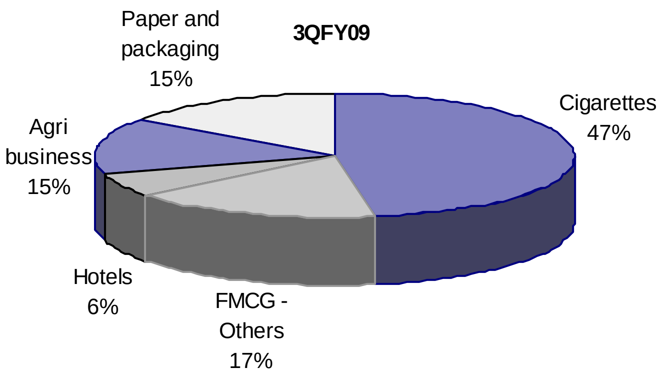
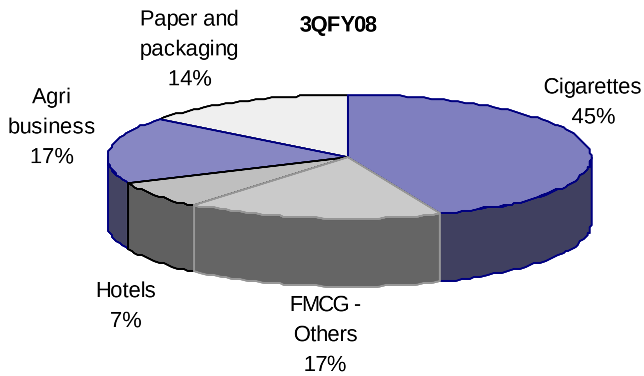
SEGMENTAL PERFORMANCE

ITC - SEGMENTAL	2QFY07	3QFY07	4QFY07	1QFY08	2QFY08	3QFY08	4QFY08	1QFY09	2QFY09	3QFY09
Sales Growth %, YoY										
Cigarettes	13.9	13.8	14.3	8.9	5.5	7.6	8.8	5.7	10.9	10.5
FMCG - Others	65.9	67.6	63.1	50.8	43.3	50.1	50.3	27.9	29.4	11.7
Hotels	30.5	28.5	15.6	11.3	12.5	11.4	11.5	17.3	10.1	-13.7
Agri Business	86.6	19.5	15.5	27.6	-14.7	-9.4	28.1	32.3	16.7	-6.2
Paper and Packaging	11.1	11.0	12.2	4.9	17.7	11.2	16.2	23.9	22.6	10.9
EBIT Margin (%)										
Cigarettes	25.4	25.3	22.5	27.3	26.4	27.2	24.3	26.4	27.8	56.9
FMCG - Others	-12.0	-10.6	-9.7	-8.2	-6.2	-9.8	-16.0	-17.7	-15.3	-17.6
Hotels	28.8	42.0	38.5	29.0	29.2	43.9	42.1	32.9	27.6	33.7
Agri Business	5.3	2.8	0.9	3.8	1.3	4.2	3.4	4.2	8.8	8.1
Paper and Packaging	21.2	19.2	18.2	16.5	20.4	19.6	19.8	18.9	16.2	16.6

Source: Company/MOSL

SALES MIX





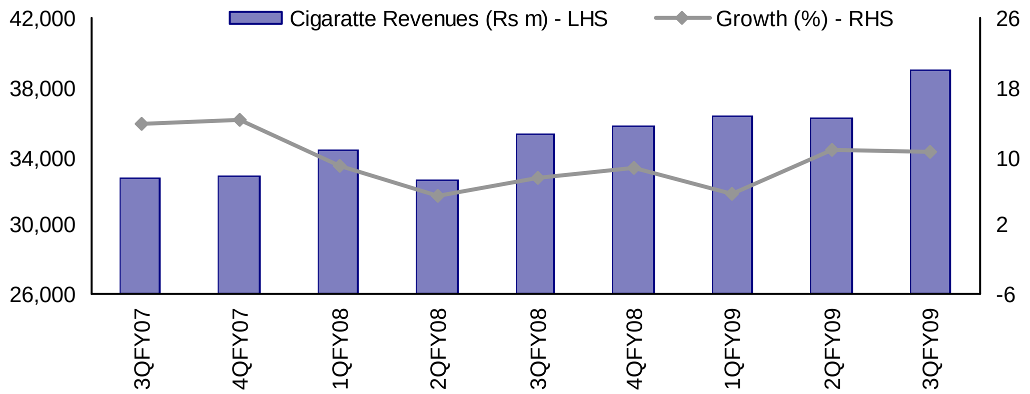
Source: Company/MOSL

Cigarette volumes decline 3.5%

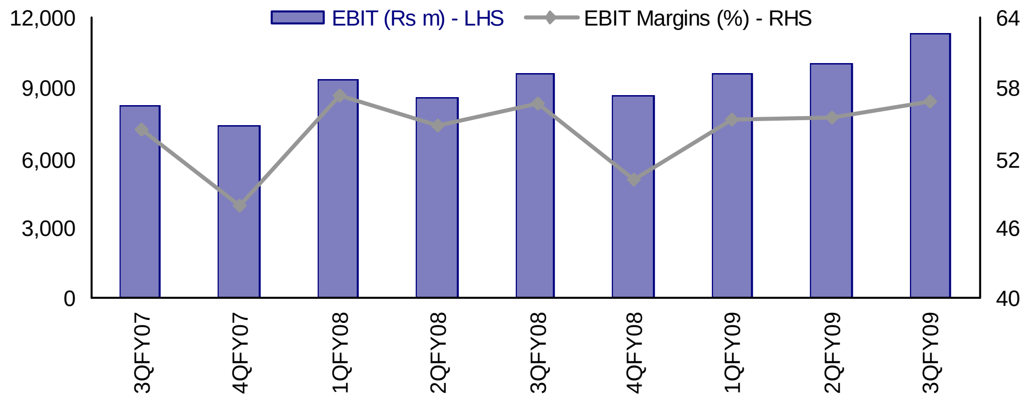
Cigarette volumes declined 3.5% (3% in 9MFY09) consequent to ITC discontinuing sale of non-filter cigarettes (19% of volumes). Volume decline was much higher than our expectation of 2% decline. The company has recently increased the price of its Gold Flake Premium from Rs27/10 cigarettes to Rs28/10, while price of Silk cut has been reduced by 8%. The impact on sales and profits is not much as these brands constitute hardly 5-6% of volumes. We are increasing FY09 cigarette volume decline estimate to 3% from 2%.

Cigarette business gross sales grew 10.5%, while PBIT grew 18% as margin expanded 10bp. The business has been facing strong regulatory headwinds (VAT, excise on non-filters and ban on smoking in public places) from past couple of years. Likely implementation of pictorial warnings will bring regulations at par with best in the world.

CIGARETTE – STEADY REVENUE GROWTH



CHANGE IN MIX AND PRICE INCREASE IMPROVES OPERATING PERFORMANCE



Source: Company/MOSL

Other FMCG - slowdown and margin focus retards topline growth

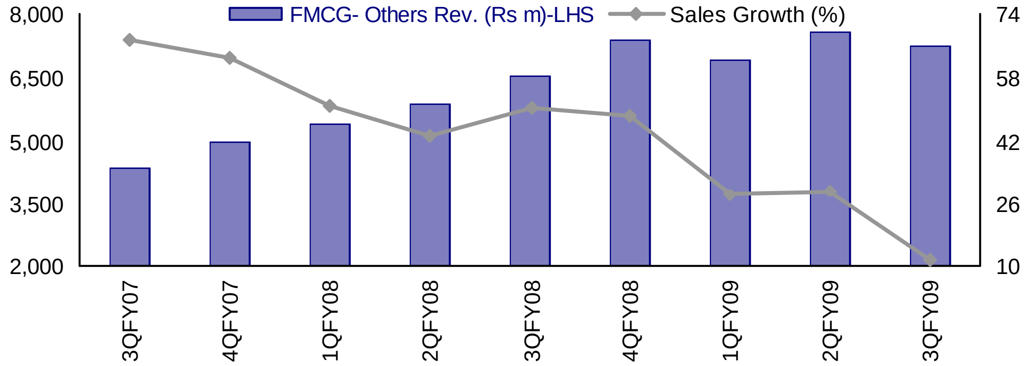
New FMCG businesses posted modest growth of 11% to Rs7.2b, while PBIT losses increased by 97% to Rs1.27b (Rs1.16b in 2QFY09). PBIT margin declined 230bp QoQ and 761bp YoY.

Processed foods: Lower growth in processed foods was due to slowdown in urban demand for certain categories. Increase in raw material cost on the back of high fuel price impacted the margins of branded food category. The company has changed its strategy by focusing on consolidation of the portfolio in select high margin categories. '*Bingo*!' product range reported flat growth, while other packaged food products posted modest growth.

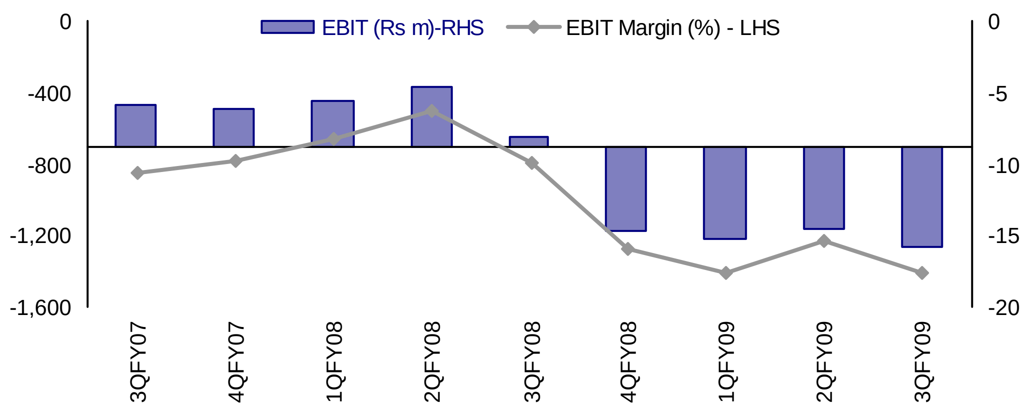
Lifestyle retailing: Lifestyle retailing has been impacted due to slowdown in the economy. ITC's apparel brand John Player has posted a year-on-year decline. Margin remained under pressure due to rising lease rental costs.

Personal care: ITC continues to expand its presence in this category and has extended its soaps brand to shampoos. It plans to increase offerings in order to gain footprint among the national branded players. The company has recently launched Vivel Ultrapro range of anti-dandruff shampoo. All the key brands like Fiama Di Wills, Vivel Di Wills, Vivel and Superia continued to gain consumer franchise. High raw material cost and increase in advertising spend has impacted the operating performance of the division and the trend is likely to continue in the coming quarter. We expect personal care products to gain momentum from 1QFY10.

OTHER FMCG – SALES CURTAILMENT IN FOODS LOWERS GROWTH



LOSS IN OTHER FMCG CONTINUES TO INCREASE

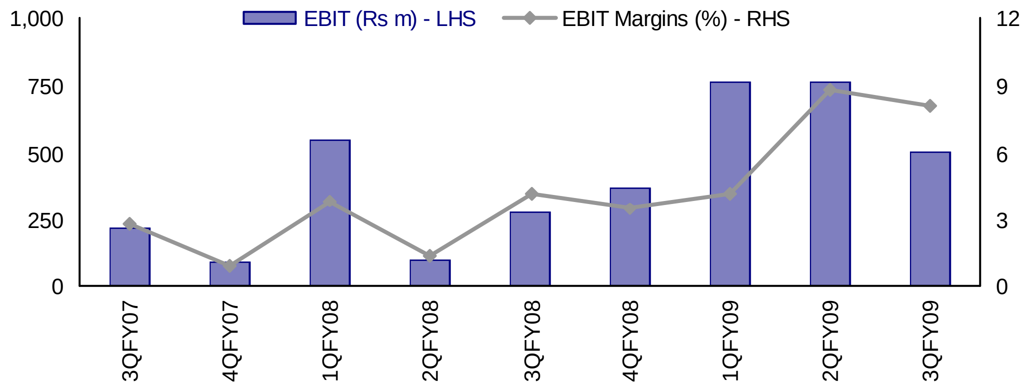


Source: Company/MOSL

Agri business - Spurt in leaf tobacco prices boost operating performance

Agri business reported a 6% decline in sales to Rs6.2b due to lower volumes of soya and rationalization of the agri-commodity portfolio. PBIT grew 80% YoY to Rs502m as margin expanded 390bp to 8.1%. Higher realization in leaf tobacco exports enabled the division to report margin expansion despite 80% increase in price of Mysore leaf tobacco crop. The capital employed has declined due to reduced focus on commodity exports. The company has only added 3-4 Choupal Sagars in the current year, while e-Choupal has not been expanded. Future expansion of e-Choupal will be in line with requirement of raw materials from processed foods.

INCREASE IN REALIZATION OF LEAF TOBACCO BOOSTS MARGIN

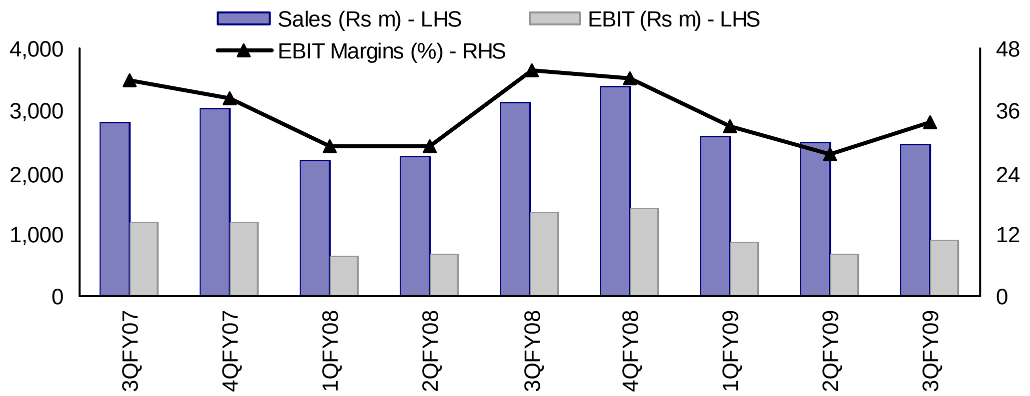


Source: Company/MOSL

Hotels: Occupancies and room rents take a hit

Hotel business reported 14% decline in sales and 34% decline in PBIT as margin declined by 10.25%. Slowdown in economy and terror strikes at Mumbai resulted in decline in occupancy levels to 60% as against 75-80% during the peak season. ARR (average revenue per room) also declined by 5-6% due to large number of cancellations. March quarter is expected to be better than 3QFY09, although performance will continue to remain under pressure in the coming 2-3 quarters. New properties in Bangalore and Chennai are progressing as per the expectation of management and would commence operation from 1QFY09 and FY11 respectively.

HOTELS – OPERATING MARGIN TO REMAIN UNDER PRESSURE



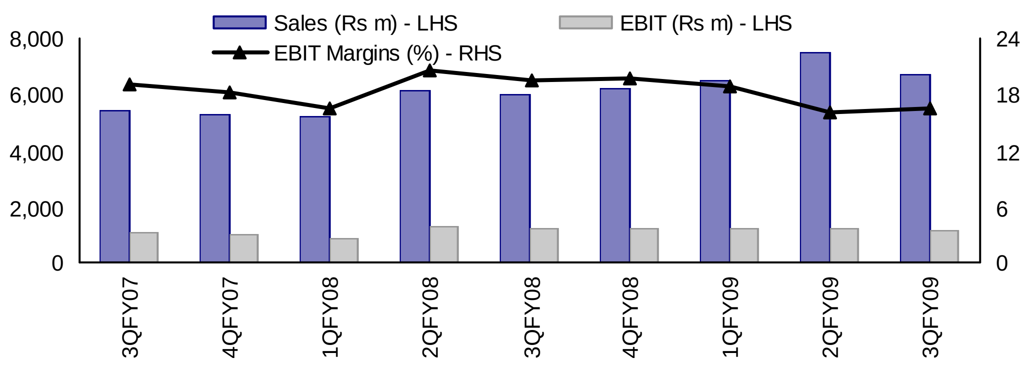
Source: Company/MOSL

Paper and paperboards: Rising input costs impact margin

Paper and paperboards reported 13.6% increase in sales and 6.1% decline in PBIT as margins declined by 300bp, although QoQ margins expanded 40bp. Increase in depreciation on new writing paper unit and higher cost inventory of coal, fuel and pulp impacted margins. New (1lac ton pa) writing and printing paper unit and 1.2lac ton pa pulp mill is now operational. Benefits from new units will start getting reflected from 4QFY09. The company has entered the copier paper segment in 7-8 markets and is currently taking the product national with focus on large institutional clients.

ITC has deferred proposed expansion of paperboard capacity by 80,000tpa and plans to fully scale up and stabilize current facilities. This will enable focus on high value segments and improve profitability.

PAPER AND PAPERBOARD – STEADFAST PERFORMANCE



Source: Company/MOSL

Valuation and view

ITC seems to be re-visitng its mega expansion plans after fast paced growth in past few years. The entire organisational focus seems to be shifting from topline growth to scaling up the businesses to the optimum and focus on profitability. Freeze on expansion in E Choupal, processed foods focus on high margin products and deferment of capacity expansion in paperboard give a strong indication of profitability focus. We believe that cigarette and paper business will continue to be key profit drivers in the near term while hotels and New FMCG will continue to remain under pressure. We are cutting earnings estimates to factor in higher losses in New FMCG and profit decline in hotel business. Our revised EPS estimate for FY09 is Rs8.7 (v/s Rs8.95 earlier; cut of 2.8%) and FY10 is Rs10.2 (v/s Rs10.4 earlier, cut of 2%). ITC trades at 19.6x FY09 EPS and 16.8x FY10E EPS. **Buy**.

VALUATION BASIS	BASIS OF VALUATION (X)	SOTP (RS/SH)
Cigarettes	EV/EBITDA - 12.5	158
Paper	EV/EBITDA - 4.5	9
Agri	EV/EBITDA - 2.0	1
New FMCG	EV/Sales - 1.5	14
Hotels	EV/EBITDA - 7.0	8
Investments		15
Target Price (Rs		**204**

Source: Company/MOSL

ITC: an investment profile

Company description

ITC is an associate of BAT (British American Tobacco) controls more than 2/3rd of the cigarette market in India. ITC has emerged as a diversified conglomerate with leading presence in Paperboards, Hotels and Processed foods. E-Choupal, the agri rural initiative of the company has been widely appreciated for its foresight in harnessing the potential in the rural market.

Key investment arguments

- Strong pricing power due to dominant market share in the cigarettes
- Hotels and Paperboard businesses have achieved self sustenance levels
- Fastest growing company in the processed food sector
- Excellent long term potential in its rural initiative of E Choupal and Choupal Sagar

Key investment risks

- A high indirect tax regime could dampen cigarette growth.
- Higher than expected losses in New FMCG business will impact profitability.

Recent developments

- Nil

Valuation and view

- Our revised estimates for FY09 and FY10 are Rs8.7 (v/s Rs9) and Rs10.2 (v/s Rs10.4) respectively.
- The stock trades at 19.6x FY09E EPS of Rs8.7 and 16.8x FY10E EPS of Rs10.2. Maintain **Buy.**

Sector view

- We have a cautious view on the sector on the back of inflationary tendency in the economy, which might impact volumes as well as profit margins of companies.
- Companies with low competitive pressures and broad product portfolios will be able to better withstand any slowdown in a particular segment.
- Longer-term prospects are bright, given rising incomes and low penetration.

COMPARATIVE VALUATIONS

		ITC	HUL	NESTLE
P/E (x)	FY09E	19.6	27.6	26.6
	FY10E	16.8	22.4	20.9
EV/EBITDA (x)	FY09E	12.4	24.5	17.1
	FY10E	10.7	19.2	13.4
EV/Sales (x)	FY09E	3.7	3.2	3.3
	FY10E	3.2	2.9	2.7
P/BV (x)	FY09E	4.7	29.3	22.2
	FY10E	4.1	22.9	17.3

SHAREHOLDING PATTERN (%)

	DEC-08	SEP-08	DEC-07
Promoter	0.0	0.0	0.0
Domestic Inst	37.9	38.2	37.6
Foreign	47.1	46.8	47.4
Others	15.0	15.1	15.1

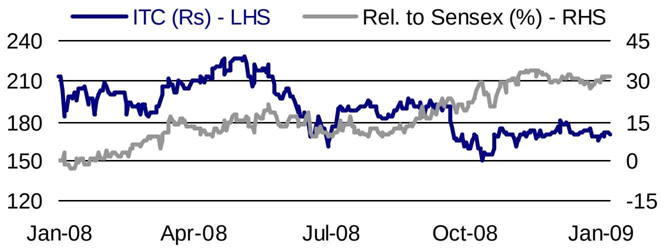
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY09	8.7	9.1	-4.5
FY10	10.2	10.6	-3.9

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
171	204	19.3	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					(RS MILLION)
Y/E MARCH	2006	2007	2008	2009E	2010E
Revenues	**98,956**	**121,643**	**139,475**	**159,026**	**180,658**
Change (%)	*27.3*	*22.9*	*14.7*	*14.0*	*13.6*
Total Expenditure	-64,578	-82,005	-95,363	-111,077	-126,022
EBITDA	**34,378**	**39,638**	**44,113**	**47,950**	**54,635**
Change (%)	*17.3*	*15.3*	*11.3*	*8.7*	*13.9*
Margin (%)	*34.7*	*32.6*	*31.6*	*30.2*	*30.2*
Depreciation	-3,323	-3,629	-4,385	-5,486	-5,538
Int. and Fin. Charges	-173	-107	-120	-100	-90
Other Income - Recurring	2,861	3,365	6,109	5,795	7,264
Profit before Taxes	**33,743**	**39,267**	**45,718**	**48,159**	**56,271**
Change (%)	*20.2*	*16.4*	*16.4*	*5.3*	*16.8*
Margin (%)	*34.1*	*32.3*	*32.8*	*30.3*	*31.1*
Tax	-10,584	-11,946	-13,690	-14,688	-17,163
Deferred Tax	696	-321	-827	-722	-844
Tax Rate (%)	*-29.3*	*-31.2*	*-31.8*	*-32.0*	*-32.0*
Profit after Taxes	**23,855**	**27,000**	**31,201**	**32,748**	**38,264**
Change (%)	*21.0*	*13.2*	*15.6*	*5.0*	*16.8*
Margin (%)	*24.1*	*22.2*	*22.4*	*20.6*	*21.2*
Non-rec. (Exp)/Income	-450	0	0	0	0
Reported PAT	**23,405**	**27,000**	**31,201**	**32,748**	**38,264**

BALANCE SHEET					(RS MILLION)
Y/E MARCH	2006	2007	2008	2009E	2010E
Share Capital	3,755	3,762	3,769	3,769	3,769
Reserves	86,860	100,609	116,808	133,053	153,379
Net Worth	**90,615**	**104,371**	**120,577**	**136,821**	**157,147**
Loans	1,197	2,009	2,144	2,009	2,009
Deferred Liability	3,248	4,729	5,451	4,522	3,457
Capital Employed	**95,060**	**111,108**	**128,172**	**143,352**	**162,613**
Gross Block	62,272	71,343	89,597	101,597	108,597
Less: Accum. Depn.	-20,654	-23,895	-27,909	-33,395	-38,933
Net Fixed Assets	**41,617**	**47,448**	**61,688**	**68,202**	**69,664**
Capital WIP	2,434	8,661	11,268	5,000	5,000
Investments	35,170	30,678	29,346	42,237	54,784
Curr. Assets, L&A	**51,619**	**62,897**	**70,193**	**77,259**	**87,906**
Inventory	26,363	33,540	40,505	45,271	52,431
Account Receivables	5,480	6,367	7,369	8,496	9,528
Cash and Bank Balance	8,558	9,002	5,703	6,132	6,944
Others	11,218	13,988	16,616	17,359	19,003
Curr. Liab. and Prov.	**35,781**	**38,576**	**44,323**	**49,346**	**54,741**
Account Payables	21,484	23,434	27,397	31,197	34,989
Other Liabilities	2,674	3,478	3,735	4,042	4,419
Provisions	11,622	11,664	13,191	14,107	15,333
Net Current Assets	**15,838**	**24,321**	**25,870**	**27,913**	**33,166**
Application of Funds	**95,060**	**111,108**	**128,172**	**143,352**	**162,613**

E: MOSt Estimates

RATIOS					
Y/E MARCH	2006	2007	2008	2009E	2010E
Basic (Rs)					
EPS	**6.3**	**7.2**	**8.3**	**8.7**	**10.2**
Cash EPS	7.2	8.1	9.5	10.2	11.6
BV/Share	24.1	27.7	32.0	36.4	41.8
DPS	2.6	3.1	3.5	3.7	4.1
Payout %	41.8	43.2	42.3	43.1	40.1
Valuation (x)					
P/E		23.8	20.6	19.6	16.8
Cash P/E		20.9	18.0	16.8	14.6
EV/Sales		5.0	4.4	3.7	3.2
EV/EBITDA		15.2	13.8	12.4	10.7
P/BV		6.1	5.3	4.7	4.1
Dividend Yield (%)		1.8	2.1	2.2	2.4
Return Ratios (%)					
RoE	26.3	25.9	25.9	23.9	24.3
RoCE	35.7	35.4	35.8	33.7	34.7
Working Capital Ratios					
Debtor (Days)	20	19	19	20	19
Asset Turnover (x)	1.0	1.1	1.1	1.1	1.1
Leverage Ratio					
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT					(RS MILLION)
Y/E MARCH	2006	2007	2008	2009E	2010E
OP/(loss) before Tax	31,055	36,009	39,728	42,464	49,097
Int./Div. Received	2,861	3,365	6,109	5,795	7,264
Depreciation and Amort.	3,323	3,629	4,385	5,486	5,538
Interest Paid	-173	-107	-120	-100	-90
Direct Taxes Paid	-10,584	-11,946	-13,690	-14,688	-17,163
(Incr)/Decr in WC	-2,782	-8,040	-4,848	-1,614	-4,441
Deff Tax	-513	1,481	722	-929	-1,065
CF from Operations	**23,187**	**24,391**	**32,287**	**36,414**	**39,141**
(Incr)/Decr in FA	-5,382	-15,299	-20,861	-5,732	-7,000
(Pur)/Sale of Investments	3,577	4,492	1,332	-12,892	-12,547
CF from Invest.	**-1,804**	**-10,805**	**-19,528**	**-18,621**	**-19,544**
Issue of Shares	650	424	446	0	0
(Incr)/Decr in Debt	-1,256	812	136	-136	0
Dividend Paid	-11,347	-13,645	-15,432	-16,504	-17,938
Exceptional Income	-450	0	0	0	0
Others	-979	-732	-1,208	-725	-847
CF from Fin. Activity	**-13,382**	**-13,142**	**-16,058**	**-17,364**	**-18,785**
Incr/Decr of Cash	**8,001**	**444**	**-3,298**	**429**	**812**
Add: Opening Balance	557	8,558	9,002	5,703	6,132
Closing Balance	**8,558**	**9,002**	**5,703**	**6,132**	**6,944**

N O T E S

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Disclosure of Interest Statement	ITC
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No