Batlivala & Karani

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UPDATE

LARGE CAP

ITC

Maintain Outperformer

Price: Rs 251	BSE Index: 17,344	30 December 2009

Share Data

Reuters code	ITC.BO
Bloomberg code	ITC IN
Market cap. (US$ mn)	20,318
6M avg. daily turnover (US$ mn)	27.1
Issued shares (mn)	3,788
Target price (Rs)	275

Performance (%)	1M	3M	12M
Absolute	(2)	8	46
Relative	(5)	6	(18)

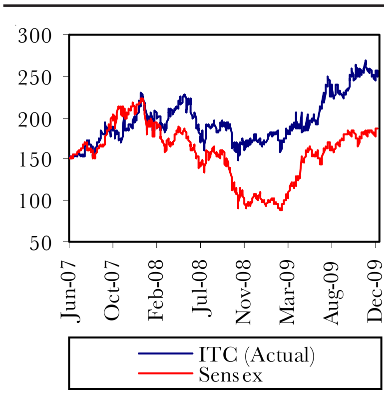
Valuation Ratios

Yr to 31 Mar	FY10E	FY11E
EPS (Rs)	10.5	12.4
+/- (%)	21.7	17.8
PER (x)	23.8	20.2
PBV (x)	6.1	5.4
Dividend/Yield (%)	2.0	2.2
EV/Sales (x)	5.3	4.6
EV/EBITDA (x)	15.3	13.1

Major shareholders (%)

FIIs	13
MFs	15
BFSI's	23
Public & Others	49

Relative performance



All round performance to continue

Cigarettes – Buoyant volumes, higher margins to drive growth

The strong momentum in cigarette volumes post the Union Budget has sustained and despite the company having increased prices across its portfolio by an average of ~4.5% in FY10, cigarette volumes are expected to deliver a volume growth of ~6.5%. Though leaf tobacco prices have stabilised in the recent auctions, the company will continue to see inflation of ~10-15% in FY11 due to high cost of inventory in FY10. With improvement in sales mix and price increases, we expect the company to sustain the current high margins (28.5% PBIT margin) posted in 1HFY10 in the future. Despite strong conversions from non-filter to filter, trade costs are expected to remain high on account of the heightened competitive activity by Godfrey Philips in the south and east markets.

The cigarette industry has been pitching for the introduction of a micro-filter (not exceeding 60 mm) segment at a new excise slab (current slab is Rs 819 for a filter not exceeding 70 mm) in the Union Budget. This will allow organised players to introduce cigarettes at Rs 1-1.5 per stick, a space which is currently held by the contraband (smuggled cigarettes) market and constitutes 6-7% of overall cigarette volumes. This proposal, if accepted, could boost volume growth for the organised players as they currently have little or no presence at the above price points.

FMCG – Cost management initiatives delivering results

The company's rationalisation process has resulted in containment of costs across the FMCG division. In the foods portfolio, the company has seen pick up in growth rates of Bingo and with rationalisation in biscuits completed, the company expects this category to grow at low double digits and achieve break-even in FY10. Though the company is adequately covered until FY10, high sugar and wheat prices remain a concern and the company could resort to price increases or grammage reductions in FY11 if the high input cost scenario persists. The personal product portfolio continues to witness month on month growth with Vivel and Superia performing well. The company is expected to enter into a new personal product category by end of FY10. It has consolidated its retail division, having shut down five stores under the Wills Lifestyle and 35-40 stores under John Players brands. Further renegotiation of rentals by 15-20% has also aided in limiting losses and the company expects retail to achieve break-even by FY11. A pickup in the performance of the retail division, as well as improvement in profitability in the foods portfolio (excluding Bingo) will result in losses declining by 25-30% in FY11 from ~Rs 3.7 bn expected in FY10.

Hotels – Revival in sight, strong FY11 expected

Though occupancies have seen a month on month improvement for the division since October 2009, room rents continue to be lower (YoY) and the company expects a full recovery only in FY11 with improvement in occupancies and strong ARR growth. Further, the new 290 room property in Bangalore, soft launched in November 2009, will be fully commission in January 2010 (100 rooms to be opened).

Apart from the 600 room Chennai property to be launched by end FY11, the company will also add a 100 room boutique hotel in Gurgaon and a 400 room property in Calcutta, which will be commissioned post FY11. An increase in room inventory and strong improvement in RevPAR's in FY11 is expected to contribute to a strong earnings growth for the division in FY11.

Others (Paper and Agri division) – Margin expansion led growth to continue

The **paper division** continues to see strong margin expansion led growth which is expected to sustain as the company is operating at optimum capacity levels for its new capacity additions. Further, the company has seen strong demand for its value-added paperboards from the consumer sector in particular, which have been upgrading to using better quality paperboard, thus benefitting ITC, which is the market leader in this segment. With strong demand for its value added paperboards and no new major capacity addition being expected in FY11, we expect strong margin expansion led growth from this division to continue in the future.

Agri division margins have been bolstered by the high realisations on the leaf tobacco exports in 1HFY10. The company expects PBIT margins to stabilise around 10% and continue focusing on leaf tobacco and soya as primary export commodities.

Outlook and valuation

After two years (FY08 and FY09) of declining cigarette volumes, ITC has recorded cigarette volume growth similar to FY07 levels (7.1%) in 1HFY10, in spite of the frequent pricing action taken in the last 18 months. In the future, with a favourable demand environment and barring any significant increase in excise duties in the Union Budget we are increasing our volumes assumptions and now expect cigarette volumes to deliver a CAGR of 6.2% for the FY09-11E period. Steep reduction in losses in the FMCG division and higher earnings growth from the hotels and paper divisions in FY11E will further boost earnings growth. Taking the improved performance into account, we have revised our FY11E earnings upwards by 2.6% and we now expect the ITC to post strong earnings CAGR of 20% for the FY09-11E period. We maintain our positive stance and Outperformer rating on the stock with a revised SOTP based target price of Rs 275 (revised from Rs 269). A higher than expected decline in FMCG losses and an introduction of a micro filter segment, boosting cigarette volumes, could provide upsides to our earnings estimates, respectively.

Revision in estimates

(Rs mn)	FY10E			FY11E		
	Old	New	Change (%)	Old	New	Change (%)
Net sales	170,448	170,610	0.1	194,284	195,403	0.6
EBITDA	58,458	59,170	1.2	67,444	69,430	2.9
EBITDA margin (%)	34.3	34.7	–	34.7	35.5	–
PAT	39,409	39,783	0.9	45,675	46,881	2.6
EPS (Rs)	10.4	10.5	0.9	12.1	12.4	2.6

SOTP valuation

Value of division	Rs/share	Notes
Cigarettes (A)	**223.4**	Based on DCF valuation
FMCG	13.3	2x FY11E sales to categories that have broken even, 1x FY11E to the other categories
Hotels	12.6	Based on 12x FY11E EV/EBITDA
Paper & Paperboards	12.8	At 10% premium to Ballarpur's valuations on a EV/EBITDA basis
Agribusiness	8.8	6x FY11E EBITDA plus replacement cost of the Choupal Network
Cash and investment in subsidiaries	17.0	At current valuations
Total of the non-cigarettes business divisions	64.4	
20% discount	12.9	
Discounted value of the non-cigarettes business lines (B)	**51.5**	
Total (A+B)	**274.9**	

Income Statement

Yr end 31 Mar (Rs mn)	FY08	FY09	FY10E	FY11E
Net sales	**139,475**	**153,881**	**170,610**	**195,403**
Growth (%)	*14.7*	*10.3*	*10.9*	*14.5*
Operating expenses	(95,247)	(104,844)	(111,440)	(125,972)
Operating profit	44,229	49,037	59,170	69,430
EBITDA	**44,229**	**49,037**	**59,170**	**69,430**
Growth (%)	*10.7*	*10.9*	*20.7*	*17.3*
Depreciation	(4,385)	(5,494)	(5,650)	(6,082)
Other income	5,920	4,897	5,289	5,908
EBIT	**45,764**	**48,441**	**58,809**	**69,257**
Interest paid	(46)	(183)	(305)	(314)
Pre-tax profit (before non-recurring)	45,718	48,257	58,504	68,943
Pre-tax profit (after non-recurring)	45,718	48,257	58,504	68,943
Tax (current + deferred)	(14,810)	(15,651)	(18,721)	(22,062)
Net profit (before Minority Interest, Pref. Dividend, etc.)	30,908	32,606	39,783	46,881
Prior period adjustments	293	30	0	0
Reported PAT	31,201	32,636	39,783	46,881
Adjusted net profit	**31,201**	**32,636**	**39,783**	**46,881**
Growth (%)	*15.6*	*4.6*	*21.9*	*17.8*

Balance Sheet

Yr end 31 Mar (Rs mn)	FY08	FY09	FY10E	FY11E
Cash & marketable sec.	26,592	29,778	42,631	53,749
Other current assets	64,490	71,287	72,269	80,137
Investments	8,456	8,923	8,323	8,456
Net fixed assets	72,957	84,860	95,187	104,777
Total assets	**172,495**	**194,848**	**218,411**	**247,120**
Current liabilities	44,323	47,050	53,578	59,730
Total debt	2,144	1,776	1,135	1,135
Other non-current liabilities	5,451	8,672	8,672	8,672
Total liabilities	**51,918**	**57,498**	**63,384**	**69,537**
Share capital	3,769	3,774	3,780	3,780
Reserves & surplus	116,808	133,576	151,246	173,803
Shareholders' funds	**120,576**	**137,350**	**155,026**	**177,583**
Total equity & liabilities	**172,495**	**194,848**	**218,411**	**247,120**
Capital employed	**128,172**	**147,798**	**164,833**	**187,390**

Cash Flow Statement

Yr end 31 Mar (Rs mn)	FY08	FY09	FY10E	FY11E
Pre-tax profit	45,718	48,257	58,504	68,943
Depreciation	4,385	5,494	5,650	6,082
Change in working capital	(6,629)	(4,963)	(229)	(3,927)
Total tax paid	(14,093)	(12,444)	(18,721)	(22,062)
Other operating activities	293	30	0	0
Cash flow from oper. (a)	**29,674**	**36,374**	**45,204**	**49,036**
Capital expenditure	(20,861)	(16,862)	(15,978)	(15,672)
Change in investments	1,332	968	(3,291)	(2,934)
Others	(371)	(535)	(0)	0
Cash flow from inv. (b)	**(19,900)**	**(16,429)**	**(19,269)**	**(18,606)**
Free cash flow (a+b)	**9,774**	**19,945**	**25,936**	**30,430**
Equity raised/(repaid)	446	448	6	0
Debt raised/(repaid)	136	(369)	(641)	0
Dividend (incl. tax)	(13,645)	(15,432)	(16,339)	(22,113)
Others	0	40	0	0
Cash flow from fin. (c)	**(13,063)**	**(15,313)**	**(16,973)**	**(22,113)**
Net chg in cash (a+b+c)	**(3,290)**	**4,632**	**8,962**	**8,317**

Key Ratios

Yr end 31 Mar (%)	FY08	FY09	FY10E	FY11E
Adjusted EPS (Rs)	8.3	8.6	10.5	12.4
Growth	15.4	4.4	21.7	17.8
Book NAV/share (Rs)	31.8	36.2	40.9	46.8
Dividend/share (Rs)	3.5	3.7	5.0	5.5
Dividend payout ratio	49.5	50.1	55.6	51.9
Tax	32.4	32.4	32.0	32.0
EBITDA margin	31.7	31.9	34.7	35.5
EBIT margin	32.8	31.5	34.5	35.4
RoCE	38.3	35.1	37.6	39.3
Net debt/Equity	(20.3)	(20.4)	(26.8)	(29.6)

Valuations

Yr end 31 Mar (x)	FY08	FY09	FY10E	FY11E
PER	30.3	29.0	23.8	20.2
PCE	26.5	24.8	20.9	17.9
Price/Book	7.9	6.9	6.1	5.4
Yield (%)	1.4	1.5	2.0	2.2
EV/Net sales	6.5	5.9	5.3	4.6
EV/EBITDA	20.5	18.5	15.3	13.1

Du Pont Analysis – ROE

Yr end 31 Mar (x)	FY08	FY09	FY10E	FY11E
Net margin (%)	22.4	21.2	23.3	24.0
Asset turnover	0.9	0.8	0.8	0.8
Leverage factor	1.4	1.4	1.4	1.4
Return on equity (%)	27.7	25.3	27.2	28.2

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Analyst Declaration: We, Harit Kapoor & Ashit Desai, hereby certify that the views expressed in this report accurately reflect our personal views about the subject securities and issuers. We also certify that no part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendation or view expressed in this report.

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B&K Investment Ratings:

1. **BUY:** Potential upside of > +25% (absolute returns)
2. **OUTPERFORMER:** 0 to +25%
3. **UNDERPERFORMER:** 0 to -25%
4. **SELL:** Potential downside of < -25% (absolute returns)

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