Company Focus

14 November 2007 | 12 pages

ITC (ITC.BO)

Buy: Fundamentals Improving Amid Attractive Valuations

- **Buying opportunity** — Cigarette volumes are stabilizing and could surprise positively, personal care expansion is unlikely to lead to excessive "cash burn" and we expect a benign tax environment ahead. Against this backdrop, ITC's stock is trading at the lower end of its historical trading band (17x FY09E P/E), providing a favorable risk-reward trade off. Buy (1L).

- **Cigarette volume decline arrested** – Our discussions with the management suggest that the cigarette volume decline has been arrested. Volumes have been flat over the last 2 months, after declining about 3.5% in 2QFY08E. Product mix has also not deteriorated, as volumes have declined mainly at the lower-end brands. We expect cigarette volumes to start growing from 4QFY08.

- **Personal care rolling out** — ITC is looking to ramp up its personal care presence (soaps and shampoos currently) over the next 8 quarters. Existing consumer businesses (excluding 'Bingo') are on course to break even by 4QFY08. According to management, while marketing spends behind the personal care business will increase, they are unlikely to be "excessive."

- **Expect benign tax environment** — Consensus on VAT took two years to build, and it seems unlikely that the rate would be revised anytime soon. Also, VAT being an ad-valorem tax linked to gross sales, state collections will likely continue to increase, keeping the incentive for a rate hike muted. In addition, a possible decline in volumes in FY08E is likely to keep the excise rate increased in-line with recent hikes (5%-6%).

Buy/Low Risk	1L
Price (14 Nov 07)	Rs183.20
Target price	Rs215.00
Expected share price return	17.4%
Expected dividend yield	1.9%
Expected total return	**19.3%**
Market Cap	Rs689,674M US$17,580M

Price Performance (RIC: ITC.BO, BB: ITC IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	22,354	6.00	10.0	30.5	7.5	26.4	1.5
2007A	27,000	7.18	19.5	25.5	6.6	27.7	1.7
2008E	33,176	8.82	22.9	20.8	5.6	29.2	1.9
2009E	40,466	10.76	22.0	17.0	4.7	30.2	2.3
2010E	49,613	13.19	22.6	13.9	4.0	31.1	2.7

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	30.5	25.5	20.8	17.0	13.9
EV/EBITDA adjusted (x)	19.5	16.4	13.3	10.6	8.4
P/BV (x)	7.5	6.6	5.6	4.7	4.0
Dividend yield (%)	1.5	1.7	1.9	2.3	2.7
Per Share Data (Rs)					
EPS adjusted	6.00	7.18	8.82	10.76	13.19
EPS reported	6.00	7.18	8.82	10.76	13.19
BVPS	24.34	27.74	32.57	38.58	46.13
DPS	2.67	3.10	3.54	4.20	5.00
Profit & Loss (RsM)					
Net sales	97,905	123,693	143,809	168,680	198,073
Operating expenses	-67,955	-87,758	-99,750	-114,208	-130,533
EBIT	**29,950**	**35,935**	**44,060**	**54,472**	**67,539**
Net interest expense	-119	-33	-30	-30	-30
Non-operating/exceptionals	2,411	3,365	3,365	3,366	3,366
Pre-tax profit	**32,242**	**39,267**	**47,395**	**57,808**	**70,875**
Tax	-9,888	-12,267	-14,218	-17,342	-21,262
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**22,354**	**27,000**	**33,176**	**40,466**	**49,613**
Adjusted earnings	22,354	27,000	33,176	40,466	49,613
Adjusted EBITDA	33,274	39,564	48,333	59,334	72,782
Growth Rates (%)					
Sales	30.9	26.3	16.3	17.3	17.4
EBIT adjusted	29.1	20.0	22.6	23.6	24.0
EBITDA adjusted	26.4	18.9	22.2	22.8	22.7
EPS adjusted	10.0	19.5	22.9	22.0	22.6
Cash Flow (RsM)					
Operating cash flow	**19,507**	**22,952**	**31,908**	**42,757**	**52,049**
Depreciation/amortization	3,323	3,629	4,274	4,862	5,242
Net working capital	-2,739	-7,677	-5,542	-2,571	-2,806
Investing cash flow	**-1,797**	**-11,178**	**-16,000**	**-16,000**	**-16,000**
Capital expenditure	-5,382	-15,299	-7,000	-7,000	-7,000
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**-11,201**	**-10,950**	**-17,038**	**-17,832**	**-21,228**
Borrowings	-1,256	812	-2,009	0	0
Dividends paid	-11,347	-13,645	-15,030	-17,832	-21,228
Change in cash	**6,509**	**824**	**-1,131**	**8,925**	**14,821**
Balance Sheet (RsM)					
Total assets	**130,840**	**149,684**	**172,952**	**203,116**	**240,333**
Cash & cash equivalent	9,110	9,544	8,413	17,337	32,157
Accounts receivable	5,480	6,367	9,850	11,553	13,567
Net fixed assets	44,051	56,109	58,835	60,973	62,731
Total liabilities	**40,226**	**45,313**	**50,434**	**57,965**	**66,799**
Accounts payable	21,890	23,848	27,122	31,069	35,527
Total Debt	1,197	2,009	0	0	0
Shareholders' funds	**90,615**	**104,371**	**122,517**	**145,150**	**173,534**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	34.0	32.0	33.6	35.2	36.7
ROE adjusted	26.4	27.7	29.2	30.2	31.1
ROIC adjusted	42.5	39.6	40.5	46.3	54.5
Net debt to equity	-8.7	-7.2	-6.9	-11.9	-18.5
Total debt to capital	1.3	1.9	0.0	0.0	0.0

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Cigarette Volumes Stabilizing

Our discussions with ITC management suggest that the cigarette volume trend continues to improve. Post 3.5% decline in 2QFY08, volumes have now started to stabilize and have not declined over the last 8 quarters. Cigarette volumes have surprised positively, demonstrating strong resilience after 20% price hikes affected by ITC in April-May following imposition of VAT at 12.5% rate. We expect volumes to start to grow again by 4QFY08. We are currently assuming 2% volume decline for FY08E. Given that overall volumes have fared better in 1HFY08, compared to our FY08 estimates, we believe that there are strong chances of positive surprises on volumes ahead. We enumerate below sensitivity of ITC's earnings to cigarette volumes:

Figure 1. FY08E Earnings Sensitivity to Cigarette Volume Growth

Cigarette Volume Growth (%)	PAT (Rsm)	% Change from Base Case
-4.0	31,363.8	-5.5
-3.0	32,270.0	-2.7
Base Case -2.0	**33,176.2**	**0.0**
-1.0	34,082.0	2.7
0.0	34,988.5	5.5
1.0	35,894.6	8.2
2.0	36,800.8	10.9
3.0	37,706.9	13.7
4.0	38,613.1	16.4

Source: Citi Investment Research

Product Mix Stable, Margins Could Surprise

According to management, volume declines have mainly been at the lower-end brands (non-filter cigarettes), and product mix has not deteriorated. Given that price hikes are heavily loaded in favor of the mid-segment brands, we believe that stable product mix bodes well for cigarette business margins. Even if consumers were to trade down, typically it would be confined within the same segment, i.e., a regular size filter smoker is unlikely to shift toward plains or micros, but likely to shift to a cheaper brand within the regular size cigarettes. Our price hike analysis suggests that such trading down could potentially benefit margins. This could particularly play out in the longs segment, which accounts for 65% of overall volumes. In this segment, prices have been hiked by 15% for the most expensive brand (Gold Flake Premium), but increased by 42%-74% for cheaper brands like Bristol and Flake filters. While we do not have specific margin profile of each brand, we believe that given the extent of the price hike differentials, it is very likely that trading down would enhance margins.

Figure 2. ITC – Segment Wise Price Hike Analysis

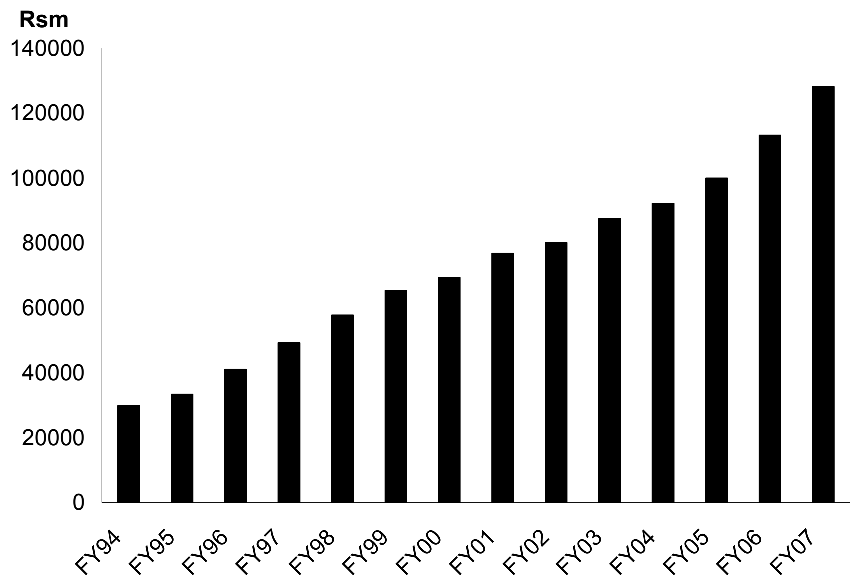
Brand / Segment	Old per stick price (Rs)	New per stick price (Rs)	Inc. in price per stick (Rs)	FY07 per stick excise (Rs)	FY08 per stick excise (Rs)	FY08 VAT per stick (Rs)	FY07 net realization per stick (Rs)	FY08 net realization per stick (Rs)	Change in net realization (Rs)	% Change in net realization
KSFT - 10% of volumes										
555 FT Kings	4.00	4.50	0.50	1.725	1.811	0.45	1.88	1.78	-0.09	-4.8
B. & H. Special	4.00	4.50	0.50	1.725	1.811	0.45	1.88	1.78	-0.09	-4.8
B. & H. Lights	4.00	4.50	0.50	1.725	1.811	0.45	1.88	1.78	-0.09	-4.8
India FT. Kings	4.50	5.00	0.50	1.725	1.811	0.51	2.33	2.18	-0.14	-6.1
India Kings Lights	4.50	5.00	0.50	1.725	1.811	0.51	2.33	2.18	-0.14	-6.1
Classic FT Kings	3.50	4.00	0.50	1.725	1.811	0.40	1.43	1.38	-0.04	-2.8
Classic Mild FT Kings	3.50	4.00	0.50	1.725	1.811	0.40	1.43	1.38	-0.04	-2.8
Classic Menthol FT Kings	3.50	4.00	0.50	1.725	1.811	0.40	1.43	1.38	-0.04	-2.8
Classic Ultra FT Kings	3.50	4.00	0.50	1.725	1.811	0.40	1.43	1.38	-0.04	-2.8
Gold Flake Light Kings	3.30	3.80	0.50	1.725	1.811	0.38	1.25	1.23	-0.02	-1.6
Gold Flake FT Kings	3.40	3.80	0.40	1.725	1.811	0.38	1.34	1.23	-0.11	-8.2
Silk Cut	NA	3.50	NA	1.725	1.811	0.35	NA	0.99	NA	
Longs - 5% of volumes										
Wills FT (Twin)	2.90	3.40	0.50	1.2980	1.363	0.34	1.31	1.35	0.04	3.0
Regulars - 65% of Volumes										
Gold Flake Prm. FT	1.90	2.40	0.50	0.803	0.843	0.24	0.91	1.07	0.17	18.5
Bristol FT	1.45	1.95	0.50	0.803	0.843	0.20	0.50	0.72	0.21	42.4
Bristol FT TT	1.45	1.95	0.50	0.803	0.843	0.20	0.50	0.72	0.21	42.4
Bristol Menthol FT	1.45	1.95	0.50	0.803	0.843	0.20	0.50	0.72	0.21	42.4
Capstan FT	1.40	1.90	0.50	0.803	0.843	0.19	0.46	0.68	0.22	47.7
Wills Flake FT	1.25	1.75	0.50	0.803	0.843	0.18	0.32	0.56	0.23	72.4
Scissors FT	1.45	2.00	0.55	0.803	0.843	0.20	0.50	0.75	0.25	50.4
Scissors Menthol FT	1.45	2.00	0.55	0.803	0.843	0.20	0.50	0.75	0.25	50.4
Silk Cut	NA	2.00	NA	0.803	0.843	0.20	NA	0.75	NA	
Plains - 10% volumes										
Gold Flake	1.50	1.75	0.25	0.535	0.562	0.18	0.82	0.84	0.02	2.6
Scissors NP	1.25	1.50	0.25	0.535	0.562	0.15	0.59	0.64	0.05	7.9
Micros - 10% volumes	**0.45**	**0.50**	**0.05**	**0.160**	**0.168**	**0.05**	**0.25**	**0.23**	**-0.01**	**-5.5%**

Source: Cigarette dealers; Citi Investment Research

What is the Near-Term Taxation Risk?

Given that ITC's cigarette business now attracts taxes from two different quarters – excise (central tax) and VAT (state tax) – there are concerns that the taxation risk has increased, particularly from an increase in the VAT rate. While remaining cognizant of the potential risk, we believe that chances for an increase in FY09E VAT rate are slim. As such, it took 2 years for the empowered committee of States to build consensus at the current rate, and it is unlikely that a change could occur soon. Additionally, VAT is an "ad-valorem" tax and collections for states will continue to increase as long as gross sales realization continues to grow, irrespective of cigarette volumes. Given ITC's policy of passing on all tax hikes, it is unlikely that its gross sales could de-grow in any year, which in turn should also lead to increased VAT collections for states year after year. Historically ITC's gross cigarette sales have not ever declined on a year-on-year basis, despite sharp volume declines in certain years. Thus, states may not feel a strong need to increase the actual rate of VAT. With a likely decline in volumes this year, the excise environment is also likely to remain benign next year.

Figure 3. ITC – Gross Cigarette Sales Trend (Rupees in Million)



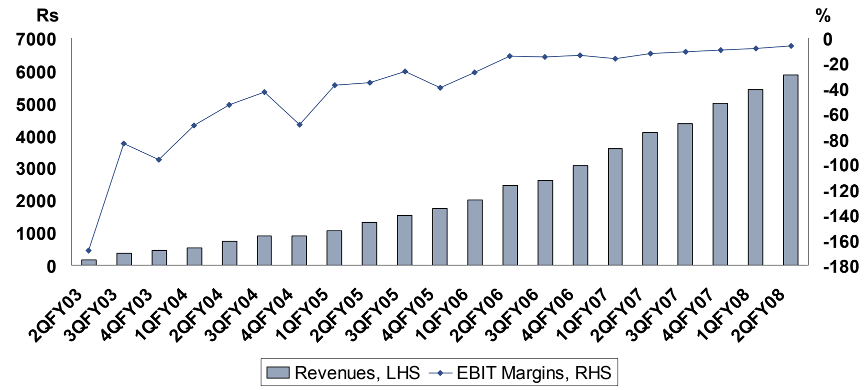
Source: Company reports

How much will personal care business bleed?

A recent concern that we have heard is that ITC's foray into the personal care segment could result in significant cash bleed, given the presence of strong incumbents in the segment. While these concerns are not unfounded, we believe that there is a strong case that these businesses are unlikely to bleed very heavily. ITC's investments in the new FMCG segments so far have demonstrated discipline over costs and most businesses have scaled up rapidly, taking market share from strong incumbents.

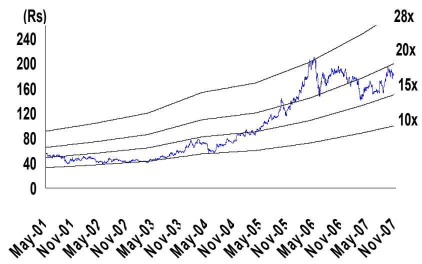
According to the ITC management, all of its non-cigarette FMCG businesses (except biscuits and wafers) have already broken even. The biscuits business losses are very marginal, and it is also likely to break even in 4QFY08E. ITC's cumulative EBIT losses over the last 6 years for its non-cigarette FMCG business are about Rs10bn, against which its has scaled up its business to almost Rs20bn annually, with current growth rates in excess of 40%. The personal care business will be rolled out nationally over the next 8 quarters, and advertising and marketing expenses will be scaled up. However, according to the management, these spends are unlikely to be "excessive" and overall margin profile for the new-FMCG business segment is unlikely to deteriorate.

Figure 4. ITC Non Cigarette FMCG Business Sales and EBIT Margin Trend (Rupees in Million, Percent)



Source: Company Reports

Figure 5. ITC P/E Bands

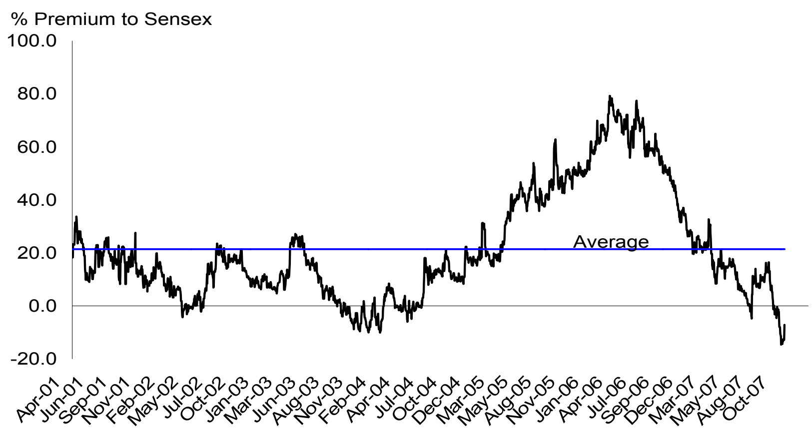


Source: DataStream, CIR

Valuations are Attractive

ITC stock has underperformed the Sensex by almost 35% over the last 12 months and currently trades at about a 9% discount to the Sensex P/E, at its historical low. Historically, the stock has traded at an average premium of 21.4% to the Sensex, and had only on two occasions before traded at a discount to Sensex P/E. The stock currently trades at a 17xFY09E P/E against FY07-FY10E EPS CAGR of 22.4%. Over the last 3 years, ITC has traded in the range of 15x-28x 1-year forward P/E. We expect a pickup in cigarette volumes to drive valuation re-rating for the stock.

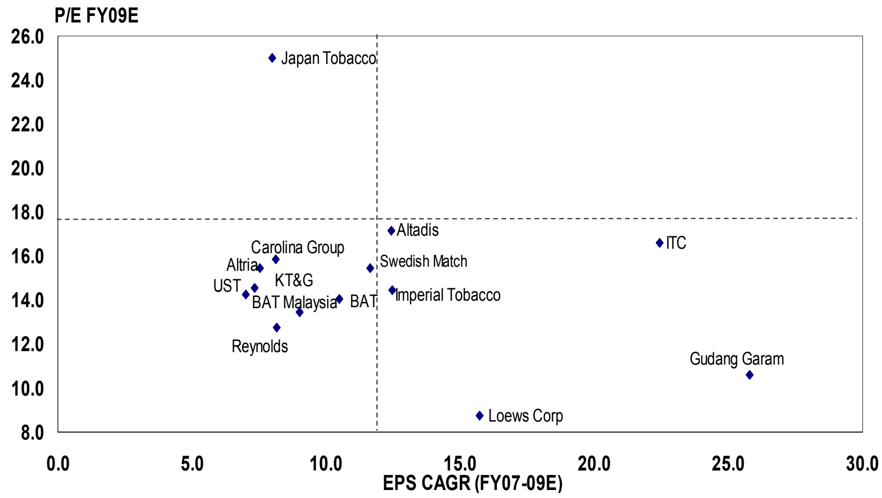
Figure 6. ITC P/E relative to Sensex P/E



Source: DataStream, CIR

Benchmarked against the global peer group average, we believe that ITC can trade at a premium of 25%-30%, given 1) its superior EPS growth CAGR, which is at almost 1.7x peer group average, 2) India is among the fastest-growing markets for cigarettes over the long term and offers long-term sustainable volume growth opportunity, against flat to declining volumes in most developed markets and 3) additionally, ITC enjoys a 70% market share and has strong pricing power, while being insulated from foreign competition.

Figure 7. Global Tobacco Stocks P/E vs. EPS CAGR



Source: Company Reports and CIR Estimates

ITC

Company description

ITC is the leading cigarette manufacturer and marketer in India with about 74% share by value. The group is 32% owned by BAT. The company's cigarette portfolio carries strong brands such as Wills, Gold Flake, India Kings and Scissors, and two of BAT's global brands, Benson & Hedges and State Express 555. Besides tobacco, ITC operates in four other business divisions, namely agri / marine products, hotels, paper & packaging and IT. However, more than 75% of its revenue is from the cigarette business. The group has made significant investments in the hotels, paperboard and processed foods (biscuits, ready-to-eat foods, confectioneries) businesses.

Investment strategy

We rate the stock as Buy /Low Risk (1L) with a target price of Rs215. ITC stock has underperformed the Sensex by 34% over the last 12 months and by 8% over the last 3 months. The stock de-rating has been triggered by a higher than expected 12.5% VAT on cigarettes, which is likely to pare cigarette volume growth. However, we believe that the worst is now behind us for ITC and that risk-reward is now turning favorable. While recent stock underperformance is already building in a cigarette volume decline in FY08E, we believe that margins could throw up positive surprises. Our analysis also suggests that consumer down trading from high end brands towards mid end brand (regular filters) may not have a negative impact on cigarette margins – on the contrary cigarette operating margins may surprise positively. If this scenario were to play out, then cigarette EBIT would grow higher than our estimates.

Valuation

Our target price of Rs215 is based on 20x FY09E earnings. Historically ITC has traded at an average premium of about 20% to Sensex valuations. Our target price is based on ITC's historical average premium to Sensex P/E. Over the last two years, ITC has traded in a valuation range of 15x-25x. With the overhang of VAT behind us, and with increasing optimism on the core cigarette business, we expect the stock valuations to be re-rated towards the higher end of its recent trading band, which justifies our 20x target multiple. ITC has a relatively stable earnings stream, so P/E is our primary valuation methodology.

Risks

We rate ITC as Low Risk because the company operates in branded businesses and its earnings volatility is low. With most of its earnings coming from the tobacco segment, ITC is most at risk from controls and the government's tax policy. Perceived as being a "sin" industry, the stock is prone to negative share price reactions. Other significant risks for the company are dilution in capital efficiency from investments in non-tobacco businesses and the possible acquisitions of capital intensive businesses that fail to enhance value. Upside risks to our target price include continuation of the government's policy of moderating excise taxes and a sharper-than-expected increase in dividend payout. If any of these factors has a greater impact than we expect, the stock could have difficulty achieving our target price.

Appendix A-1

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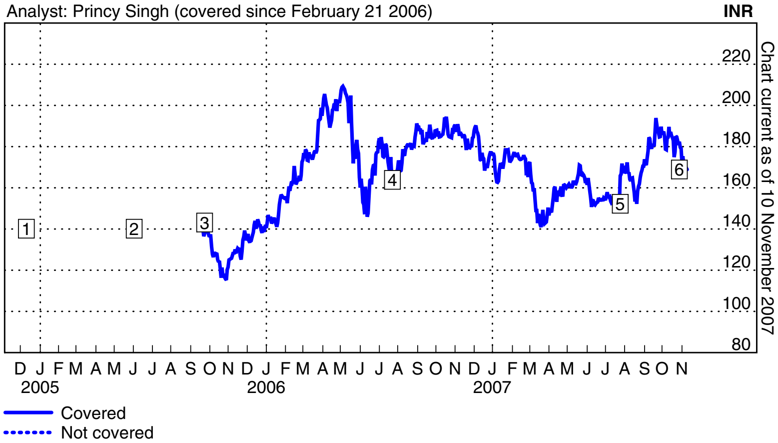
IMPORTANT DISCLOSURES

ITC (ITC.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Princy Singh (covered since February 21 2006)



#	Date	Rating	Target Price	Closing Price
1:	10 Dec 04	*3L	85.00	NA
2:	2 Jun 05	3L	*88.33	NA
3:	23 Sep 05	3L	*92.00	137.75
4:	23 Jul 06	3L	*130.00	164.30
5:	25 Jul 07	*1L	*195.00	165.85
6:	28 Oct 07	1L	*215.00	182.40

*Indicates change.

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% of companies in each rating category that are investment banking clients	53%	55%	42%

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