

Company Flash

30 October 2006 | 6 pages

ITC (ITC.BO)

2QFY07 in-line: Story remains great, but priced in.

- 2QFY07 in-line** - 2Q was line with our expectations. Key surprise was the solid 14% increase in cigarettes revenues and net profit growth of 19% to Rs6.8bn. However, EBITDA margins declined 387bps, primarily driven by high raw material costs which we believe are driven by underlying commodity inflation.
- Cigarette growth picks up** – Sales grew by 14% driven by an estimated underlying volume growth of 8%. 4% growth was due to price hikes and the rest on account of product mix change. ITC has recently taken price hikes on some key brands such as Gold Flake Kings (3%), Gold Flake Premium Filters (5%), Plain Scissors (20%) & Flake Filter (13%) which should enhance growth going forward. We understand from management that volume growth has remained stable despite price hikes.
- Hotels/Agri grew in line with expectations** – While hotels revenues grew by 31%, margins expanded by 1086bps. Revenues per available room (REVPAR) grew by 37%. Agri revenues grew by 87% while the margins dropped by 132 bps.
- Other FMCG losses are coming down** – Driven by a strong 66% revenue growth. Though on an absolute level, the losses were higher by 39% at Rs490m, the EBIT margins improved by 236 bps. Management maintains its FY07 breakeven guidance for its other FMCG business.
- Valuations pricing in growth** – While the growth story remains strong, at 25.5x FY07E earnings, the growth seems priced in. VAT related overhang is likely to come into play during budget (Feb 07) which will impact the stock performance. Maintain Sell.

Sell/Low Risk	3L
Price (30 Oct 06)	Rs188.30
Target price	Rs130.00
Expected share price return	-31.0%
Expected dividend yield	1.6%
Expected total return	-29.4%
Market Cap	Rs707,615M US\$15,709M

Figure 1. Statistical Abstract

Year to 31-Mar	Net Profit (Rs Mils.)	FD EPS (Rs)	EPS Growth (%)	P/E (x)	DPS (Rs)	Yield (%)	RoE (%)
2005	21,914.2	5.89	37.3	31.9	2.1	1.1	30.6
2006	22,353.5	6.00	2.00	31.2	2.3	1.2	26.4
2007E	27,344.7	7.34	22.33	25.5	3.0	1.6	27.9
2008E	32,309.0	8.68	18.15	21.6	3.3	1.8	28.2
2009E	37,646.1	10.11	16.52	18.5	3.5	1.9	27.9

Source: Company Reports and Citigroup Investment Research

Princy Singh¹

+91-22-6631-9871
 princy.singh@citigroup.com

Pragati Khadse¹

+91-22-6631-9856
 pragati.khadse@citigroup.com

See page 4 for Analyst Certification and important disclosures.

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ITC: 2QFY07 Results

Figure 2. ITC – 2QFY07 Results Summary (Rupees in Millions, Percent)

	2QFY06	2QFY07	% Change
Gross sales	37,381.8	46,248.8	23.7
Excise duty	-15,550.3	-17,372.8	11.7
<i>Excise %</i>	<i>41.6</i>	<i>37.6</i>	<i>-403bps</i>
Net sales	21,831.5	28,876.0	32.3
Expenditure	-13,633.1	-19,149.1	40.5
Operating profit	8,198.4	9,726.9	18.6
<i>OPM (%)</i>	<i>37.6</i>	<i>33.7</i>	<i>-387bps</i>
Interest	3.2	-34.8	-1187.5
Depreciation	-829.8	-909.7	9.6
Other income	780.6	794.8	1.8
PBT	8,152.4	9,577.2	17.5
Tax	-2,429.1	-2,781.6	14.5
<i>Tax rate (%)</i>	<i>29.8</i>	<i>29.0</i>	<i>-75bps</i>
PAT	5,723.3	6,795.6	18.7
<i>Net Profit Margin (%)</i>	<i>26.2</i>	<i>23.5</i>	<i>-268bps</i>
Cost Details			
Raw Materials	8,091.9	12,310.9	52.1
<i>% of Sales</i>	<i>37.1</i>	<i>42.6</i>	<i>557bps</i>
Staff Cost	1,364.5	1,496.7	9.7
<i>% of Sales</i>	<i>6.3</i>	<i>5.2</i>	<i>-107bps</i>
Other Expenditure	4,176.7	5,341.5	27.9
<i>% of Sales</i>	<i>19.1</i>	<i>18.5</i>	<i>-63bps</i>

Source: Company Reports

Figure 3. ITC – Segmental Revenues and Profitability (Rupees in Millions, Percent)

Segment Revenues	2QFY06	2QFY07	% Change
Cigarettes	27,231.1	31,017.4	13.9
Other FMCG	2,469.0	4,096.0	65.9
Total FMCG	29,700.1	35,113.4	18.2
Hotels	1,539.7	2,009.6	30.5
Agri Business	4,656.1	8,687.8	86.6
Paperboard & Paper	4,699.5	5,220.0	11.1
Total	40,595.4	51,030.8	25.7
Less: Inter Segment Sales	3,213.6	4,782.0	48.8
Gross Sales	37,381.8	46,248.8	23.7
Segment EBIT			
Cigarettes	6,829.7	7,866.3	15.2
<i>EBIT Margin (%)</i>	<i>25.1</i>	<i>25.4</i>	<i>28bps</i>
Others	-353.4	-489.8	38.6
<i>EBIT Margin (%)</i>	<i>-14.3</i>	<i>-12.0</i>	<i>236bps</i>
Total FMCG	6,476.3	7,376.5	13.9
<i>EBIT Margin (%)</i>	<i>21.8</i>	<i>21.0</i>	<i>-80bps</i>
Hotels	275.5	577.8	109.7
<i>EBIT Margin (%)</i>	<i>17.9</i>	<i>28.8</i>	<i>1086bps</i>
Agri Business	308.6	460.9	49.4
<i>EBIT Margin (%)</i>	<i>6.6</i>	<i>5.3</i>	<i>-132bps</i>
Paperboard & Paper	918.6	1,108.6	20.7
<i>EBIT Margin (%)</i>	<i>19.5</i>	<i>21.2</i>	<i>169bps</i>
Total	7,979.0	9,523.8	19.4
Less: Interest (Net)	-3.2	34.8	-1187.5
Net Unallocable Expenses	-170.2	-88.6	-47.9
PBT & Exceptionals	8,152.4	9,577.6	17.5

Source: Company Reports

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 Thesis

We rate the stock as Sell/Low Risk (3L) with a target price of Rs130. We think ITC is expensive on all counts vs. its peers. We believe current cigarette volume growth is sustainable only in an environment in which the government adopts a lenient stance on excise tax hikes for cigarettes. The global paperboard cycle is showing mixed trends, and we await clarity as to its future direction. Hotels, at near peak profitability, earned 17% ROCE in FY06 and, being in a cyclical industry, these good times are unlikely to last long. In the fast-growing non-cigarette consumer businesses, the real test lies ahead. We estimate an earnings CAGR of 17% for FY06-09E.

Valuation

Our target price of Rs130 is based on 15x FY08E earnings. ITC is investing in the non-cigarette consumer businesses. We think growth from this segment should help rating multiples. However, other cyclical commodity businesses offset much of this. Historically ITC has traded in a band of +/- 10% the Sensex valuation. Our target price is based on parity with Sensex valuations. ITC has a relatively stable earnings stream, so P/E is our primary valuation methodology. We believe ITC should trade at 8-10x EV/EBITDA, the lower end of its historical trading band. The company has substantial brand equity for its core cigarette brands and will likely receive a premium over the broader market. However, some of this is diluted due to the presence of cyclical businesses. Our target price of Rs130 is also based on 9-10x FY08E EV, which would put the stock at about a 25% premium to the Sensex.

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.

Analyst Certification Appendix A-1

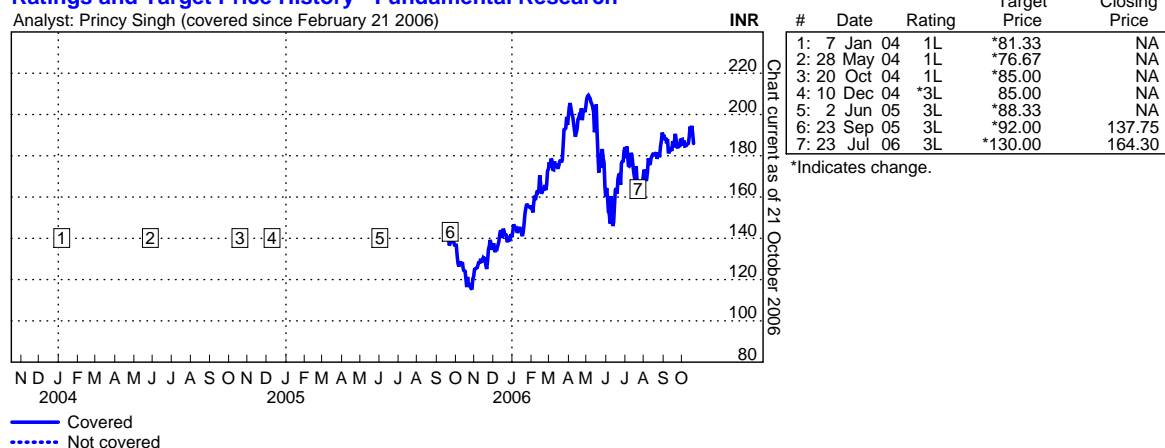
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Analyst: Princy Singh (covered since February 21 2006)



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