Indiabulls

ITC LIMITED
RESEARCH

EQUITY RESEARCH | September 22, 2009

## RESULTS REVIEW

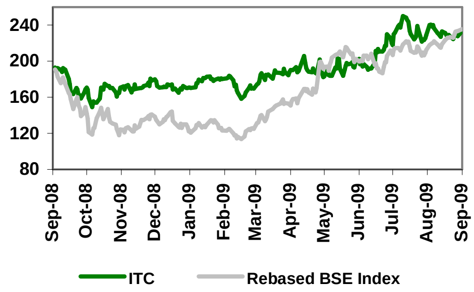
| Share Data | |
|---|---|
| Market Cap | Rs. 880.6 bn |
| Price | Rs. 233.3 |
| BSE Sensex | 16,886.43 |
| Reuters | ITC.BO |
| Bloomberg | ITC IN |
| Avg. Volume (52 Week) | 0.8 mn |
| 52-Week High/Low | Rs. 252.25 / 132.05 |
| Shares Outstanding | 3,774.4 mn |

**Valuation Ratios (Consolidated)**

| Year to 31 March | 2010E | 2011E |
|---|---|---|
| EPS (Rs.) | 9.1 | 10.3 |
| EPS Growth (%) | 10.1% | 12.6% |
| PER (x) | 25.3x | 22.5x |
| EV/Sales (x) | 5.0x | 4.5x |
| EV/EBITDA (x) | 16.2x | 14.4x |

| Shareholding Pattern (%) | |
|---|---|
| Promoters | 0 |
| FIIs | 14 |
| Institutions | 37 |
| Public & Others | 49 |

**Relative Performance**




# ITC Limited — Hold

***Cigarette business to steal the show***

ITC's Q1'10 net sales rose 4.7% yoy to Rs. 40.8 bn due to the 23.3% and 16.0% jumps in the sales of the Cigarette and Paper & Packaging businesses, respectively. EBITDA increased by 21.2% yoy to Rs. 13.9 bn in Q1'10 due to the reduction in the operating loss of the Other FMCG business. However, the Hotel business succumbed to the pressures emanating from the declining tourist inflows and the consequent plunge in occupancy rates and average room rates (ARRs). Thus, it reported a decline of 24.8% yoy in revenue for Q1'10. Assuming a sustainable volume growth in the Cigarette business, a consistent growth in the Paper business, and an expected recovery in the Hotel business from Q4'10, we have upgraded our rating on the stock from Sell to Hold with a target price of Rs. 248.

**Excise stability makes ITC better placed to absorb the impending VAT increase:** Contrary to our expectation, the Government did not propose any increase in excise duties on cigarettes for FY10. Thus, we expect ITC to maintain its volume growth in the near term. However, Maharashtra, Delhi, and Rajasthan have increased VAT on cigarettes from 12.5% to 20% in their FY10 budgets. The Company can mitigate the impact of the VAT increase by distributing the consequent price increase in FY10 and FY11 to avoid a negative impact on volumes. Factoring these, we have upgraded our revenue growth forecast to 9.8% (6.4%) for FY10.

**Near-term weakness to persist in the Hotel business:** Hotel occupancies and average room rates (ARR) have been negatively impacted by the global economic crisis, the Mumbai terrorist attacks, and then the swine flu pandemic. However, with the improving macroeconomic outlook, we expect an increase in business tourism followed by the visible recovery in FY11 owing to the upcoming Commonwealth Games. Hence, we expect the business to start recovering by the end of FY10.

**Key Figures (Standalone)**

| Quarterly Data | Q1'09 | Q4'09 | Q1'10 | YoY% | QoQ% |
|---|---|---|---|---|---|
| (Figures in Rs. mn, except per share data) | | | | | |
| Net Sales | 38,997 | 38,918 | 40,827 | 4.7% | 4.9% |
| EBITDA | 11,447 | 12,983 | 13,873 | 21.2% | 6.9% |
| Net Profit | 6,519 | 8,090 | 8,787 | 34.8% | 8.6% |
| **Margins(%)** | | | | | |
| EBITDA | 29.4% | 33.4% | 34.0% | | |
| NPM | 16.7% | 20.8% | 21.5% | | |
| **Per Share Data (Rs.)** | | | | | |
| Normalised EPS | 2.0 | 2.1 | 2.3 | 17.8% | 8.4% |

**FMCG-Other's EBIT loss to ease going forward:** The FMCG-Other's EBIT margin has come down from negative 17.7% in Q1'09 to negative 13.1% in Q1'10. We assume operating loss would reduce further on the back of better performance from the existing product mix in personal care, packaged food, and stationary segments, as the economic recovery is likely to boost consumer spending. However, the business is likely to break even only post FY12 due to slower-than-expected revenue growth in FY09 and high initial costs.

## Valuation

We expect that the Company will show stable earning growth in the coming years on the back of volume and realisation growth from cigarette business, better product mix in FMCG others, and strong performance expected from hotel business from FY11. Moreover, our DCF-based valuation (assuming WACC of 11.5%, Rf of 7.88%, and terminal growth rate of 5%) gives a target price of Rs. 248, which provides an upside of ~7% over the current market price (CMP) of Rs. 233.3. Thus, we upgrade our rating on the Stock to Hold.

**Sensitivity Analysis of the Fair Value Estimate**

| | | Cost of Capital | | | | |
|---|---|---|---|---|---|---|
| | | 10.5% | 11.0% | 11.5% | 12.0% | 12.5% |
| Terminal Growth | 4.0% | 271 | 246 | 225 | 207 | 191 |
| | 4.5% | 287 | 259 | 236 | 216 | 199 |
| | 5.0% | 306 | 275 | 248 | 226 | 207 |
| | 5.5% | 329 | 293 | 263 | 238 | 217 |
| | 6.0% | 356 | 314 | 280 | 252 | 228 |

## Result Highlights and Outlook

ITC's net sales for Q1'10 advanced 4.7% yoy to Rs. 40.8 bn as compared to a decline of 1.1% yoy in the last quarter, thanks to the good show put up by the FMCG and the Paper & Packaging businesses, which grew handsomely on the net revenues front up by 19.4% and 16.0%, respectively. On the back of expected sustainable volume growth in Cigarette business; consistent growth in Paper business; and an expected recovery in Hotel business from Q4'10, we have increased our revenue growth for FY10 to 6.8% from 5.7%.

EBITDA increased by 21.2% yoy to Rs. 13.9 bn in Q1'10 and increased by 6.9% qoq due to a consistent reduction in the loss in other FMCG business. Consequently, we upgrade our EBITDA margin estimates for FY10 by 130 bps at 30.9%.

**Cigarette Business**

The net revenue from the Cigarette segment jumped 23.3% to Rs. 21.5 bn in Q1'10 from Rs. 17.4 bn in Q1'09. The EBIT margin improved by 61 bps qoq following price cut in the last quarter and an improvement in the product mix. Pictorial graphic warnings on cigarette packs implemented with effect from May 31, 2009 and the increase in VAT rate from 12.5% to 20.0% in Maharashtra, Delhi and Rajasthan did not have any major negative impact on its cigarettes earnings which accounts for around 50% of the total revenue. As the Union Budget for FY10 left the excise duties on cigarettes unchanged we raise our revenue forecasts by 344 bps for FY10 and expect a CAGR of 9.5% for FY09-11.

**FMCG-Others**

The revenues in the Other FMCG business was up by 9.5% yoy to Rs. 7.6 bn in Q1'10. The company is able to expand its presence in the market with the help of aggressive communication strategy and tried to reach to the consumers which has further leveraged its brand position and brand awareness among the consumers. The Company launched 'Aqua' for men in different fragrances under brand Essenza Di Wills (Super Premium) in Q1'10 which expands its product portfolio further.

We expect the improvement in macroeconomic environment would enable the Company make a better footing in the new launches supported by good response witnessed in this quarter. Furthermore, the retail stores would also witness better turnover.

However, we do not expect the business to break even before FY12 due to slower-than-expected revenue growth in FY09 and high initial costs.

**Paperboards, Paper, and Packaging Business**

The business maintained its market leadership in the Paperboard and Packaging business with net segment revenues increasing by 16% yoy to Rs. 7.0 bn. This was driven by the growth of the premium value added paperboard segment, successful penetration of the paper markets and robust performance of the packaging business. During the period, the 'Ozone bleached' Pulp mill and the paper plant, with annual capacities of 1.22 lakh tons and 1 lakh tons respectively, reached optimum levels of productivity. This production ramp-up at the new pulp and paperboard facility (the Bhadrachalam plant), which started operations three quarters ago is expected to drive synergies based on strong forward linkages with the Stationery business. The operating margin is likely to improve further with the use of cost-effective renewable energy. We forecast a revenue growth of 11.6% for FY10.

**Hotels Business**

The revenues in the Hotel business fell by 27.7% to Rs. 1.7 bn in Q1'10 over the same period last year. This decline can be attributed to the cut in the corporate spending and the weakness in the business and leisure travel. During the period, the occupancy rates and room rents have negatively impacted the Company's top line largely due to the global economic crisis, followed by the Mumbai terrorist attacks, and now the swine flu pandemic. With improving macroeconomic outlook, we expect an increase in business tourism followed by the visible recovery in FY11 owing to Commonwealth Games in the country. Hence, we expect the business to start recovering by the end of FY10.

**Agri Business**

The revenue in the Agri business was decreased by 48.7% yoy to Rs. 9.4 bn in Q1'10. Lack of market opportunities resulted in lower throughput of soya and wheat volumes, impacting agri product revenues during the period. The leaf-tobacco was the major contributor in the revenue.

## Key Risks

The following factors may pose a threat to our rating:

- A lower-than-expected increase in volumes of Cigarettes is the major downside risk to our rating
- A higher-than-expected fall in the occupancy rates and ARRs in the Hotels business is the major downside risk to our rating

**Key Figures (Consolidated)**

| Year to March | FY07 | FY08 | FY09 | FY10E | FY11E | CAGR (%) |
|---|---|---|---|---|---|---|
| (Figures in Rs mn, except per share data) | | | | | | (FY09-11E) |
| Net Sales | 126,687 | 146,591 | 163,323 | 174,414 | 193,605 | 8.9% |
| EBITDA | 40,862 | 45,681 | 50,723 | 53,960 | 60,518 | 9.2% |
| Net Profit | 27,290 | 30,021 | 31,680 | 34,485 | 38,835 | 10.7% |
| **Margins(%)** | | | | | | |
| EBITDA | 32.3% | 31.2% | 31.1% | 30.9% | 31.3% | |
| NPM | 21.5% | 20.5% | 19.4% | 19.8% | 20.1% | |
| **Per Share Data (Rs.)** | | | | | | |
| Adj EPS | 7.2 | 7.9 | 8.3 | 9.1 | 10.3 | 11.3% |
| PER (x) | 20.9x | 26.2x | 27.8x | 25.3x | 22.5x | |

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