MOTILAL OSWAL

3QFY11 Results Update
SECTOR: FMCG

ITC

BSE SENSEX	S&P CNX
19,008	5,697
Bloomberg	ITC IN
Equity Shares (m)	7,705.9
52-Week Range (Rs)	185/112
1,6,12 Rel. Perf. (%)	6/9/30
M.Cap. (Rs b)	1,301.5
M.Cap. (US$ b)	29.3

Rs169 **Buy**

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GR. (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
03/10A	183,810	40,610	5.3	24.4	31.8	9.3	29.2	40.9	6.8	19.5
03/11E	214,457	49,483	6.4	21.9	26.3	7.5	31.5	44.4	5.8	16.5
03/12E	246,591	57,943	7.5	17.1	22.5	6.4	30.7	43.9	5.0	13.8
03/13E	281,135	67,204	8.7	16.0	19.4	5.4	28.0	40.7	4.3	11.8

ITC's 3QFY11 operational results were in line with our expectations. Net sales grew 20.4% to Rs55.1b led by strong growth in cigarettes (up 18.9%), FMCG (up 23.9%) and the agri-business (up 17.9%). EBITDA margins contracted 50bp to 18.8% as EBITDA grew 18.8% YoY to Rs20.3b. Other income increased 21% due to gains from sales of investments (VST Industries and Agro Tech) and a higher yield on debt funds. PAT grew 21.4% to Rs13.9b.

- **Cigarette volume growth a pleasant surprise, margin expansion 70bp:** Net sales grew 15.6% to Rs27.7b led by ~12.5% realization growth in 3QFY11. The realization increase was led by a price increase and mix improvement, enabling EBIT growth of 17% (margin expansion of 70bp to 55.3%). We estimate cigarette volumes to have grown ~2.5% YoY (against our estimate of 2%). We are pleasantly surprised by the traction in volume growth despite ITC's sharp price increase.
- **FMCG, agri divisions post steady growth, paper, hotel recovery slow:** New FMCG business sales were up 24% YoY at Rs11b and EBIT loss declined 15% to Rs736m (loss of Rs669m in 2QFY11). The fall in losses was led by an improved product mix in biscuits and staples, supply chain efficiencies and increased benefits of scale. The agriculture business' sales were up 18% and EBIT grew 35.5% YoY, enabling margin expansion of 90bp. The hotels business' revenue grew 13.7% to Rs2.8b, which in our view was disappointing, given the economic recovery and pick-up in occupancy rates. Paper and paperboard sales rose 8.1% YoY to Rs8.8b and EBIT fell 5% YoY to Rs1.9b, due to uncertainty over statutory warnings.
- **Budget to be a near-term variable:** We are positive about the long term volume growth opportunity in cigarettes. However FY12 volume growth will be a function of the excise hike in the upcoming Budget. Preempting the changes in excise duty, ITC increased prices by ~4.2% on its portfolio. Sustained reduction in losses in the FMCG and other divisions and strong traction in the agriculture business are positive. The hotels business is recovering slowly and expected to pick up in the coming year. We expect a strong rebound by the paper and paperboard business in the coming quarter. Our estimates are unchanged after the incorporation of housekeeping changes (increase in share capital due to ESoPs and higher other income). We estimate 16.5% PAT CAGR over FY11-13. The stock trades at 22.5x FY12E EPS and 19.4x FY13E EPS. Maintain **Buy** with an SOTP-based target price of Rs190.

QUARTERLY PERFORMANCE (RS MILLION)

Y/E MARCH	FY10				FY11				FY10	FY11E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Cigarette Vol Gr (%)	5.5	7.5	8.5	8.8	-3.5	-0.5	2.5	4.0	8.3	0.5
Net Sales	**41,978**	**43,453**	**45,802**	**51,316**	**48,473**	**51,472**	**55,137**	**59,374**	**183,822**	**214,457**
YoY Change (%)	*6.7*	*12.5*	*18.7*	*28.7*	*15.5*	*18.5*	*20.4*	*15.7*	*16.3*	*16.7*
Total Exp	28,105	27,552	28,725	35,137	32,103	32,723	34,845	39,540	120,792	139,210
EBITDA	**13,873**	**15,901**	**17,076**	**16,180**	**16,371**	**18,749**	**20,293**	**19,835**	**63,031**	**75,247**
Growth (%)	19.5	30.8	23.9	24.6	18.0	17.9	18.8	22.6	24.7	19.4
Margins (%)	*33.0*	*36.6*	*37.3*	*31.5*	*33.8*	*36.4*	*36.8*	*33.4*	*34.3*	*35.1*
Depreciation	1,516	1,484	1,549	1,539	1,597	1,640	1,681	1,951	6,087	6,869
Other Income	876	684	1,591	592	985	1,245	1,930	726	3,743	4,886
PBT	**13,175**	**14,920**	**17,010**	**15,048**	**15,701**	**18,300**	**20,313**	**18,456**	**60,153**	**72,769**
Tax	4,388	4,821	5,569	4,766	4,998	5,833	6,422	6,034	19,543	23,286
Rate (%)	*33.3*	*32.3*	*32.7*	*31.7*	*31.8*	*31.9*	*31.6*	*32.7*	*32.5*	*32.0*
Reported PAT	**8,787**	**10,099**	**11,442**	**10,282**	**10,703**	**12,467**	**13,891**	**12,422**	**40,610**	**49,483**
YoY Change (%)	17.4	25.8	26.7	27.1	21.8	23.5	21.4	20.8	*24.4*	21.8

E: MOSL Estimates

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ITC's 3QFY11 operational results were in line with our expectations.

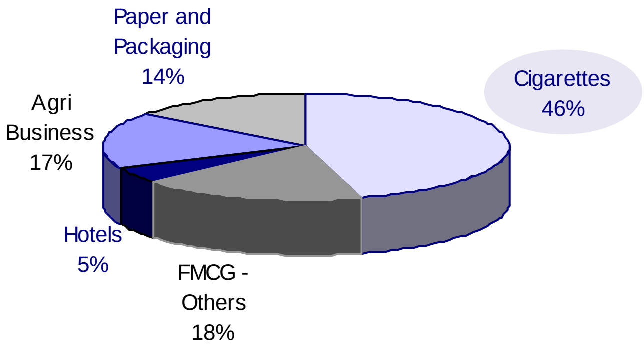
- Net sales grew 20.4% to Rs55.1b (against our estimate of Rs54b) led by strong growth in cigarettes (up 18.9%), FMCG (up 23.9%) and the agriculture business (17.9%).
- EBITDA margins contracted 50bp to 18.8% as EBITDA grew 18.8% YoY to Rs20.3b (against our estimate of Rs20.3b).
- Other income increased 21% due to a gain from the sale of investments (VST Industries and Agro Tech) and a higher yield on debt funds.
- PAT grew 21.4% to Rs13.9b (against our estimate of Rs13.4b).
- Cigarette sales grew 15.6% (volume growth of 3%) and EBIT grew 17% enabling margin expansion of 70bp to 55.3%.
- New FMCG sales grew 23.8% and EBIT losses declined 14.4%. The agriculture business grew 17.9% and EBIT growth was 35.5% due to better margins in leaf tobacco business.

Segmental performance: strong growth in cigarettes, FMCG and agriculture

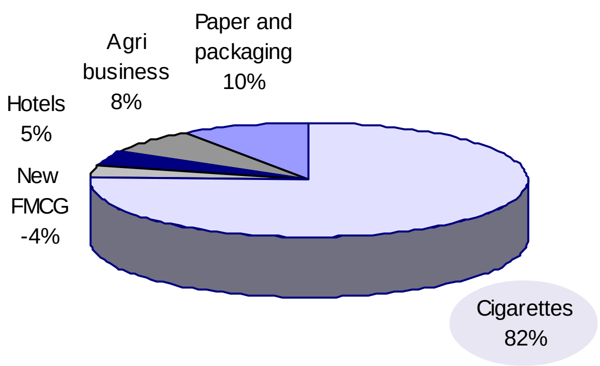
	1QFY10	2QFY10	3QFY10	4QFY10	1QFY11	2QFY11	3QFY11	% Gr.
Sales								
Cigarettes	21,456	22,590	23,990	24,530	24,836	25,501	27,726	*15.6*
FMCG - Others	7,573	8,633	8,900	11,227	10,014	10,556	11,021	*23.8*
Hotels	1,728	1,740	2,477	2,562	2,099	2,089	2,816	*13.7*
Agri business	9,406	10,283	9,052	9,881	13,498	12,496	10,667	*17.9*
Paper and packaging	7,026	7,904	8,118	8,030	7,937	9,192	8,773	*8.1*
EBIT (Rs m)								
Cigarettes	11,254	12,517	13,098	12,512	13,050	14,582	15,330	*17.0*
FMCG - Others	-998	-850	-860	-787	-893	-669	-736	*-14.4*
Hotels	306	316	763	782	385	399	886	*16.1*
Agri business	999	1,741	1,041	583	1,231	2,024	1,411	*35.5*
Paper and packaging	1,278	1,862	2,014	1,688	1,885	2,456	1,914	*-5.0*
EBIT Margin								
Cigarettes	50.9	55.4	54.6	51.0	52.5	57.2	55.3	*0.7*
FMCG - Others	-13.2	-9.8	-9.7	-7.0	-8.9	-6.3	-6.7	*3.0*
Hotels	17.7	18.1	30.8	30.5	18.3	19.1	31.5	*0.7*
Agri business	10.6	16.9	11.5	5.9	9.1	16.2	13.2	*1.7*
Paper and packaging	18.2	23.6	24.8	21.0	23.7	26.7	21.8	*-3.0*

Source: Company/MOSL

3QFY11 Sales mix



3QFY11 PBIT mix

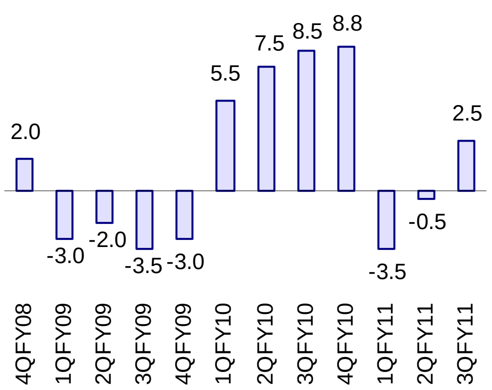


Source: Company/MOSL

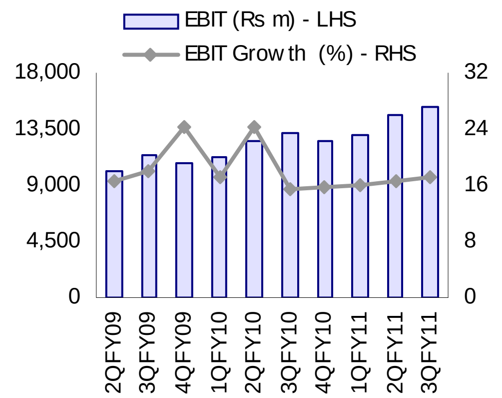
Cigarette volumes up 2.5%, higher prices, better product mix enable 70bp margin expansion

We estimate cigarette volume growth at ~2.5% YoY (est 2%); we note that price increases of more than 15% have been well absorbed in the market. Net sales grew 15.6% to Rs27.7b led by ~12.5% realization growth during the quarter. Realization increase was led by price increase and mix improvement enabling EBIT growth of 17% (margin expansion of 70bp to 55.3%). Godfrey Philips' launch of Marlboro compact and rising presence in East and South India has not yet impacted ITC's competitive positioning. Pictorial warnings change has been pushed ahead by 2 years; however, the date of implementation is not clear. Even if we assume that the notification date is Dec-2009, the current packaging will sustain till at least Dec-2011.

Cigarette volumes up 2.5%



Price hike, mix benefit enable 70bp margin expansion



Source: Company/MOSL

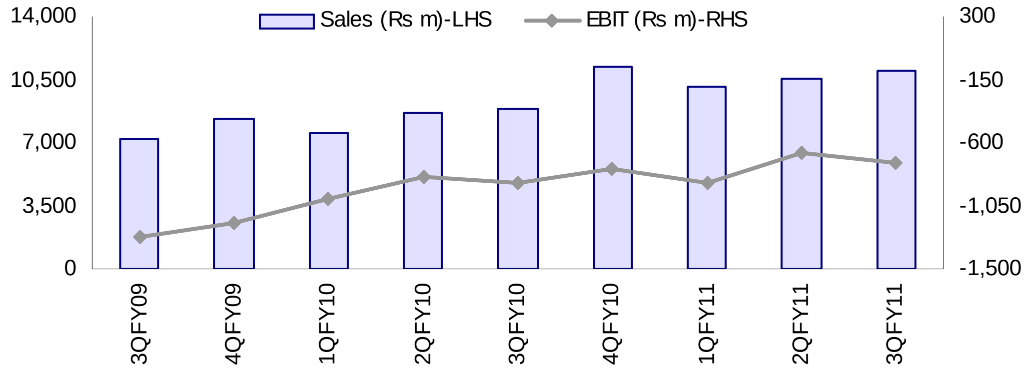
ITC has already started effecting price increases ahead of the budget (prices up ~4% in the current QTD); we do not rule out further hikes in run up to the budget. We would view an excise increase <10% to be very positive for category expansion. However, excise increase above teens would be negative for volume growth in the near term; we highlight increased resilience of cigarette volumes to price increases over the past couple of years. Our current estimates model in 5% excise increase and 6% volume growth for FY12 and FY13.

FMCG others: sales up 24%, EBIT losses down 15% YoY, packaged foods, stationery drive growth

- ITC's New FMCG business sales were up 24% YoY at Rs11b and EBIT losses declined 15% to Rs736m (2QFY11 loss Rs669m). Branded packaged food completed the fourth consecutive quarter of profitable growth.
- Branded packaged food sales grew 24% led by Sunfeast Biscuits (up 28%) and Bingo (up 48%). In 3QFY11 ITC launched Sunfeast Yipee! Noodles, which has been well received by consumers. In staples, ITC scaled up its presence in spices through the launch of Ashirvaad Rasam and Sambhar.
- ITC has maintained 3% market share in shampoo and increased its share in soaps to 6% (5% in 2QFY11). It aims to increase its market share to 10% in soaps and 7-8% in shampoo over 3-4 years. Skin cream has been well accepted and it has a new variant in shampoo.

- Education and stationery products grew 50% YoY. The leadership position of Classmate is being leveraged to enhance ITC's position in scholastic products with ITC's foray into products like geometry boxes, pens, pencils and highlighters.
- A sharp reduction in losses was led by an improved product mix in biscuits and staples, supply chain efficiency and increasing benefits of scale.
- We expect ITC's FMCG and others' EBIT losses to fall 15% in FY11 and 30% in FY12.

Healthy sales growth; loss decline lower due to sharp input costs

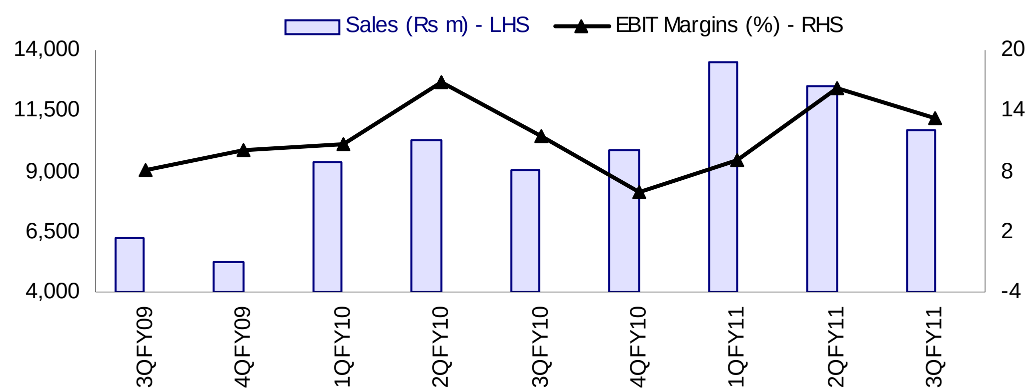


Source: Company/MOSL

Agri business: sales grow 18%, commodity inflation in soya, coffee boost margins

ITC's agriculture business posted an 18% increase in sales to Rs10.7b and EBIT grew 35.5% YoY enabling margin expansion of 90bp. The leaf tobacco business posted higher margins due to stable selling prices even as sourcing costs declined in India. The business gained due to a surge in trading volumes, particularly in soya and coffee. We believe the recent run-up in agriculture commodities also boosted margins. ITC is setting up a new leaf tobacco facility in Karnataka, which will start processing in 12 months.

Higher volumes, realizations enable sales growth, margin expansion

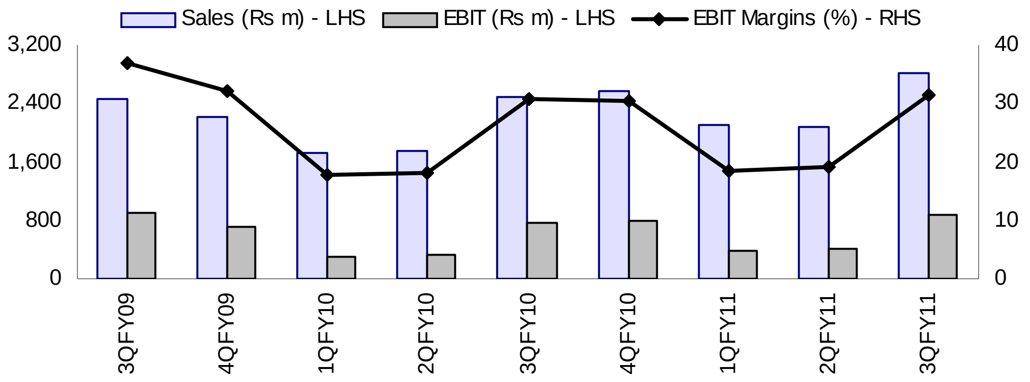


Source: Company/MOSL

Hotels business: sales up 20%, EBIT margins up 95bp

ITC's hotels business revenue grew 13.7% to Rs2.8b, a tad disappointing as a double-digit increase in ARR (average revenue per room) was neutralized by muted growth in occupancy levels (~67%) due to commissioning of new properties in ITC's key markets. EBIT grew 16.1% to Rs886m enabling margin expansion of 65bp to 31.5%. Recovery in the hotels business is expected to accelerate over 2-3 quarters. The commissioning of a 600-room Chennai property (expected by 2QFY12) will increase capacity by 20% and boost growth.

Hotels business: recovery underway; performance to improve

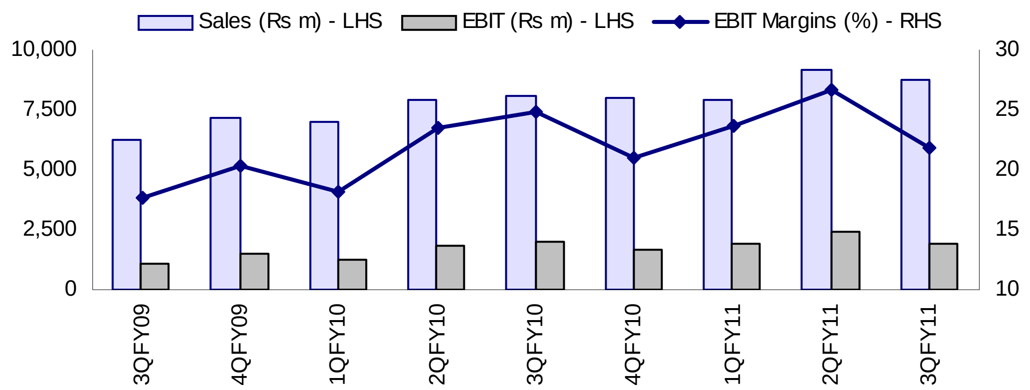


Source: Company/MOSL

Paper and paperboards: external sales strong; performance hit by uncertainty over statutory warnings

Paper and paperboard sales increased 8.1% YoY to Rs8.8b and EBIT declined 5% YoY to Rs1.9b. The segment's margin contracted 300bp YoY and 500bp QoQ. External sales were strong in 3QFY11 led by higher volumes and an improved mix (higher share of value added products). However, sales of packaging material for cigarettes were impacted by uncertainty regarding graphic statutory warnings. We believe replenishment of cigarette packaging inventory will enable the company to recoup a significant part of lost sales of 3QFY11. The commissioning of another 0.1mt paperboard line will boost operating performance in FY13.

Performance impacted by uncertainty over statutory warnings



Source: Company/MOSL

Cigarette volumes surprise positively; Budget a near-term variable; maintain Buy

We are positive about the long-term volume growth opportunity in cigarettes. However FY12 volume growth would be a function of the excise hike in the upcoming Budget. Preempting changes in excise, ITC increased prices by ~4.2% on its portfolio. Sustained reduction in FMCG others' losses and strong traction in the agriculture business are positive. The hotels business is in a slow recovery phase and should pick up in the coming year. We expect a strong rebound from the paper and paperboards business in the coming quarter. Our estimates are unchanged after the incorporation of housekeeping changes (increase in share capital due to ESoPs and higher other income). We estimate 16.5% PAT CAGR over FY11-13. The stock trades at 22.5x FY12E EPS and 19.4x FY13E EPS. Maintain **Buy** with a SOTP-based target price of Rs190.

ITC: SOTP valuation basis FY12E (Rs b)

	Sales	EBIDTA	Basis	Multiple (x)	Total EV	Rs/share
Cigarettes	135	76	EV/EBITDA	14.0	1,071	139
Paper	42	12	EV/EBITDA	6.0	71	9
Agri	66	7	EV/EBITDA	5.0	36	5
New FMCG	64	-1	EV/Sales	2.0	128	17
Hotels	14	6	EV/EBITDA	12.0	72	9
Total	**320**	**100**			**1,378**	
Gross Value					1,378	
Net Cash					**83**	
Net Value					1,461	
No of Shares					7.7	
Per share (Rs)					**190**	

Source: MOSL

ITC: an investment profile

Company description

ITC, an associate of BAT (British American Tobacco), controls more than two-thirds of India's cigarette market. ITC has emerged as a diversified conglomerate with a leading presence in paperboard, hotels and processed foods. E-Choupal, the company's agri-rural initiative, has been widely appreciated for its foresight in harnessing rural market potential.

Key investment arguments

- ITC has strong pricing power due to a dominant share in the cigarette market.
- Its paperboard business has achieved self sustenance levels.
- Its hotel business recovering steadily.

Key investment risks

- Increase in excise in the forthcoming Budget could be a risk to volume growth assumptions for cigarettes.
- Higher-than-expected losses in its New FMCG business will impact profitability.

Recent developments

- ITC entered the high growth instant noodles market with Sunfeast Yippies brand.
- ITC plans to add 1,500 rooms in 3-4 years (addition of ~50% of existing capacity).
- Strong mix improvement in the paper and paperboard division due to a higher share of value-added products.

Valuation and view

- Our EPS estimates are Rs7.5 for FY12 and Rs8.7 for FY13. We estimate 16.5% PAT CAGR over FY11-13.
- The stock trades at 22.5x FY12E EPS and 19.4x FY13E EPS. Maintain **Buy** with an SOTP based target price of Rs190.

Sector view

- We are positive about the long-term demand growth in the cigarette business due to rising affordability and huge demand potential in small towns and rural areas.
- Non-cigarette businesses like hotels and paper can fund their own growth and demand potential is strong.

Comparative valuations

		ITC	HUL	Nestle
P/E (x)	FY11E	26.3	29.7	37.1
	FY12E	22.5	26.0	30.4
EV/EBITDA (x)	FY11E	16.5	22.3	25.0
	FY12E	13.8	19.1	20.6
EV/Sales (x)	FY11E	5.8	3.2	4.7
	FY12E	5.0	2.8	4.0
P/BV (x)	FY11E	7.5	21.7	43.0
	FY12E	6.4	18.3	36.5

Shareholding pattern (%)

	Sep-10	Jun-10	Sep-09
Promoter	0.0	0.0	0.0
Domestic Inst	36.1	36.8	37.6
Foreign	46.5	46.0	46.0
Others	17.4	17.2	16.3

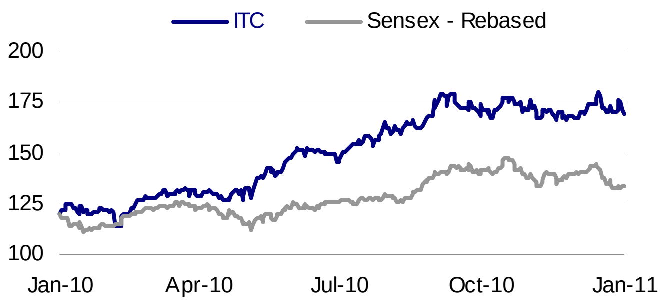
EPS: MOSL forecast v/s Consensus (Rs)

	MOSL Forecast	Consensus Forecast	Variation (%)
FY11	6.4	6.5	-0.6
FY12	7.5	7.6	-0.9

Target Price and Recommendation

Current Price (Rs)	Target Price (Rs)	Upside (%)	Reco.
169	190	12.4	Buy

Stock performance (1 year)



Financials and Valuation

INCOME STATEMENT					(RS MILLION)
Y/E MARCH	2009	2010	2011E	2012E	2013E
Net Sales	**156,119**	**181,532**	**212,359**	**244,321**	**278,675**
Operational Income	1,946	2,278	2,097	2,270	2,460
Total Revenue	**158,065**	**183,810**	**214,457**	**246,591**	**281,135**
Change (%)	*11.5*	*16.3*	*16.7*	*15.0*	*14.0*
Total Expenditure	-107,341	-120,619	-139,210	-158,235	-180,300
EBITDA	**50,724**	**63,191**	**75,247**	**88,355**	**100,836**
Change (%)	*8.9*	*24.6*	*19.1*	*17.4*	*14.1*
Margin (%)	*32.5*	*34.8*	*35.4*	*36.2*	*36.2*
Depreciation	-5,494	-6,087	-6,869	-7,634	-8,399
Int. and Fin. Charges	-376	-706	-495	-495	-495
Other Inc. - Recurring	3,403	3,756	4,886	4,982	6,885
Profit before Taxes	**48,257**	**60,153**	**72,769**	**85,210**	**98,829**
Change (%)	*5.6*	*24.7*	*21.0*	*17.1*	*16.0*
Margin (%)	*30.9*	*33.1*	*34.3*	*34.9*	*35.5*
Tax	-12,550	-20,511	-24,378	-28,545	-33,108
Deferred Tax	-3,071	968	1,092	1,278	1,482
Tax Rate (%)	*-32.4*	*-32.5*	*-32.0*	*-32.0*	*-32.0*
Profit after Taxes	**32,636**	**40,610**	**49,483**	**57,943**	**67,204**
Change (%)	*4.6*	*24.4*	*21.9*	*17.1*	*16.0*
Margin (%)	*20.9*	*22.4*	*23.3*	*23.7*	*24.1*
Non-rec. (Exp)/Income	0	0	0	0	0
Reported PAT	**32,636**	**40,610**	**49,483**	**57,943**	**67,204**

RATIOS					
Y/E MARCH	2009	2010	2011E	2012E	2013E
Basic (Rs)					
EPS	**8.6**	**10.6**	**6.4**	**7.5**	**8.7**
Cash EPS	10.1	12.2	7.3	8.5	9.8
BV/Share	36.4	36.8	22.5	26.5	31.1
DPS	3.7	10.0	2.6	3.0	3.5
Payout %	42.8	94.0	40.0	40.0	40.0
Valuation (x)					
P/E	19.5	15.9	26.3	22.5	19.4
Cash P/E	16.7	13.8	23.1	19.8	17.2
EV/Sales	8.1	6.8	5.8	5.0	4.3
EV/EBITDA	24.9	19.5	16.5	13.8	11.8
P/BV	9.5	9.3	7.5	6.4	5.4
Dividend Yield (%)	2.2	5.9	1.5	1.8	2.1
Return Ratios (%)					
RoE	25.3	29.2	31.5	30.7	28.0
RoCE	35.2	40.9	44.4	43.9	40.7
Working Capital Ratios					
Debtor (Days)	16	17	17	17	17
Asset Turnover (x)	1.1	1.2	1.2	1.2	1.1
Leverage Ratio					
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0

BALANCE SHEET					(RS MILLION)
Y/E MARCH	2009	2010	2011E	2012E	2013E
Share Capital	3,774	3,818	7,706	7,706	7,706
Reserves	133,576	136,826	165,373	196,198	231,951
Net Worth	**137,351**	**140,644**	**173,079**	**203,904**	**239,656**
Loans	1,776	1,077	1,077	1,077	1,077
Deferred Liability	8,672	7,850	6,528	5,003	3,255
Capital Employed	**147,798**	**149,571**	**180,684**	**209,984**	**243,988**
Gross Block	105,587	119,679	134,679	149,679	164,679
Less: Accum. Depn.	-32,867	-38,255	-45,123	-52,757	-61,155
Net Fixed Assets	**72,719**	**81,424**	**89,555**	**96,922**	**103,523**
Capital WIP	12,141	10,090	10,000	10,000	10,000
Investments	28,378	57,269	50,888	71,195	96,111
Curr. Assets, L&A	**81,597**	**81,271**	**92,629**	**103,760**	**116,958**
Inventory	45,997	45,491	51,748	58,504	66,619
Account Receivables	6,687	8,588	9,891	11,379	12,979
Cash and Bank Balance	10,310	11,263	12,513	13,596	15,124
Others	18,603	15,929	18,477	20,281	22,236
Curr. Liab. and Prov	**47,036**	**80,482**	**62,388**	**71,894**	**82,604**
Account Payables	29,237	34,441	37,559	42,938	49,129
Other Liabilities	3,833	7,859	5,034	5,778	6,593
Provisions	13,966	38,183	19,794	23,178	26,882
Net Current Assets	**34,561**	**788**	**30,241**	**31,867**	**34,354**
Application of Func	**147,798**	**149,571**	**180,684**	**209,984**	**243,988**

E: MOSL Estimates

CASH FLOW STATEMENT					(RS MILLION)
Y/E MARCH	2009	2010	2011E	2012E	2013E
OP/(loss) before Tax	45,230	57,104	68,379	80,722	92,437
Int./Div. Received	3,403	3,756	4,886	4,982	6,885
Depreciation and Amort	5,494	6,087	6,869	7,634	8,399
Interest Paid	-376	-706	-495	-495	-495
Direct Taxes Paid	-15,622	-19,543	-23,286	-27,267	-31,625
(Incr)/Decr in WC	-4,084	34,725	-28,202	-543	-959
Deff Tax	3,221	-822	-1,322	-1,526	-1,748
CF from Operations	**37,267**	**80,601**	**26,828**	**63,506**	**72,893**
Extraordinary Items	0	0	0	1	2
(Incr)/Decr in FA	-17,397	-12,741	-14,910	-15,000	-15,000
(Pur)/Sale of Investmen	968	-28,891	6,381	-20,308	-24,916
CF from Invest.	**-16,429**	**-41,633**	**-8,529**	**-35,307**	**-39,914**
Change in Networth	437	7,200	6,110	0	0
(Incr)/Decr in Debt	-369	-698	0	0	0
Dividend Paid	-16,299	-44,517	-23,158	-27,117	-31,451
Exceptional Income	0	0	0	0	0
CF from Fin. Activi	**-16,231**	**-38,015**	**-17,048**	**-27,117**	**-31,451**
Incr/Decr of Cash	**4,608**	**953**	**1,250**	**1,083**	**1,529**
Add: Opening Balance	5,703	10,310	11,263	12,513	13,596
Closing Balance	**10,310**	**11,263**	**12,513**	**13,596**	**15,124**

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