VISIT UPDATE

LARGE CAP

ITC

Maintain Outperformer

Price: Rs 167 | **BSE Index: 20,016** | **23 December 2010**

Share Data

Reuters code	ITC.BO
Bloomberg code	ITC IN
Market cap. (US$ mn)	28,580
6M avg. daily turnover (US$ mn)	26.5
Issued shares (mn)	7,699
Target price (Rs)	180

Performance (%)	1M	3M	12M
Absolute	(5)	(4)	39
Relative	(5)	(5)	16

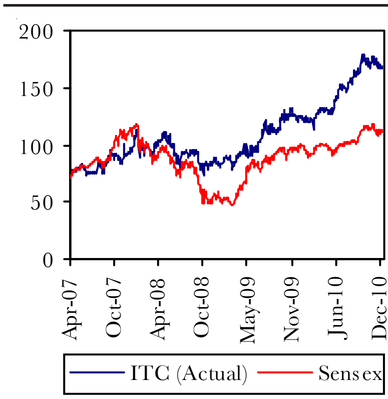
Valuation ratios

Yr to 31 Mar	FY11E	FY12E
EPS (Rs)	6.4	7.4
+/- (%)	19.8	16.1
PER (x)	26.3	22.6
PBV (x)	7.6	6.6
Dividend/Yield (%)	1.6	1.9
EV/Sales (x)	5.9	5.1
EV/EBITDA (x)	17.0	14.7

Major shareholders (%)

FIIs	14
MFs	14
BFSI's	22
Public & Others	50

Relative performance



Growth momentum intact

We met the management of ITC. Following are the key takeaways:

Cigarettes – On a strong footing

- The company expects positive volume growth in 2HFY11 led by recovery in the regular segment (Rs 2-3.5 price point). Cigarette volumes had dipped in 1HFY11 due to the steep 15% increase in excise duties. The company expects flat volume growth for FY11, in line with our assumptions.
- Competition from the launch of Marlboro's regular variant (Rs 3.5 price point) has not had a significant impact and the company is closely monitoring the progress of the brand. ITC launched 'Lucky Strike' in the kings segment (Rs 5.5 price point) in July and 'Players Gold Leaf' (Rs 3 price point) in October in a bid to increase presence at these price points. Launches at the Rs 1.5 price point (micro filter) have seen limited traction. This is due to the presence of unorganised and illegal competition at Re 1 price point that has grown significantly and now constitutes ~8% of industry volumes.
- The benefit of lower leaf tobacco prices (10-15% decline in the past three months) is expected to accrue only in FY12 because ITC maintains high tobacco inventory of ~15 months. The company believes that with improving product mix and staggered pricing increases, ~30 bps margin expansion in FY12 is sustainable.

FMCG – Strong growth momentum, losses continue to decline

- Profitability in foods has improved driven by higher margins in biscuits and staples, which has been a key factor in narrowing FMCG losses in FY11 until now. With the exception of Bingo and the recently launched noodles, the foods portfolio has been positively contributing to the division's PBIT. The company expects the FMCG division to break even at the PBIT level by FY13. Personal care, however, would take four-five years to achieve break even.
- In personal care, ITC has maintained market share at 5% in soaps and 3-3.5% in shampoos. The company has identified skin care as a major opportunity. Apart from fairness creams, it would be looking at further launches in this space.
- The company is satisfied with its launches in the noodles and fairness cream space and will be rolling out brands across markets over the next three months.

Hotels – Expect gradual improvement

- Average Room Rate (ARR) growth has been moderate with the key Delhi and Mumbai markets seeing an increase in supply. The company expects a gradual improvement in ARRs over the next seven-eight quarters as demand picks up to match supply in these markets.
- The 600-room Chennai property will be launched in 1QFY12. ITC is also planning a 100-room property in Gurgaon, a 500-room property in Kolkata, and a 120-room property in Bangalore, which would be ready for launch by FY15-16.

Other key highlights

- In 1HFY11, **paper** margins improved largely due to an improving mix (higher sales of value added paperboards). The company expects to maintain revenue growth momentum with sustainable PBIT margins of 21-22%. However, since it is operating at optimum capacity utilisation levels, paper margins could positively surprise in the next two-three quarters. To service increased paperboard demand, the company will be adding a 100,000 tonnes paperboard machine by end-FY12 at a capex of Rs 6-7 bn.
- In the **agri** division, although leaf tobacco prices have corrected 10-15%, export realisations have remained firm. Hence we do not expect a significant correction in agri margins. The company expects to maintain PBIT margins at 10-11% and would focus on higher margin exports of leaf tobacco and soya.
- The company has reduced its stake in Agrotech Foods and VST Industries and is looking to exit these investments completely in the near future.

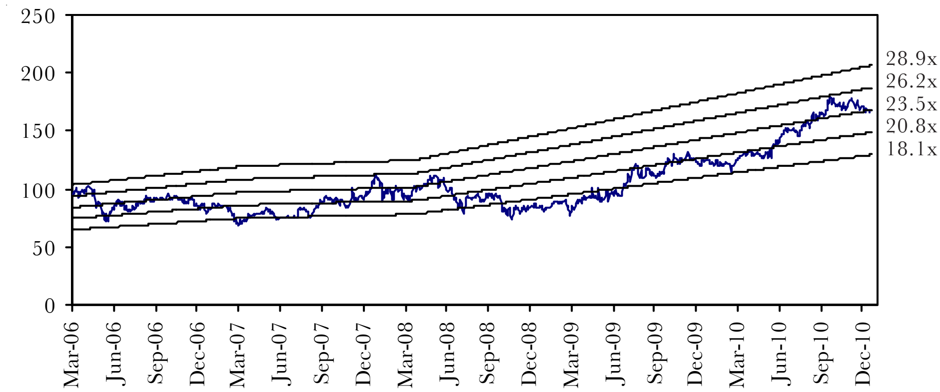
Outlook and valuation

ITC's cigarette business continues to display resilience with volumes recovering within six months following the steep 15% price increase. Providing for a moderate 5-6% increase in excise duties in the forthcoming budget, we expect cigarette volumes to grow 5%+ in FY12. Cigarette margins have continued to surprise on the upside; given a reducing input cost scenario, we expect further margin expansion, which would drive profitability in FY12. The FMCG division continues to record 20%+ growth and the company expects it to break even in FY13. Thus, losses could be much lower in FY12 versus our assumption of 35% decline. An improving volume growth outlook for cigarettes and improving profitability across divisions (except agri) are expected to drive the strong 18% earnings CAGR over FY10-12. This engenders reasonable valuations of 22.6x FY12 earnings for ITC (average FY12 P/E for our FMCG coverage universe is ~24x). We are positive on ITC and maintain our **Outperformer** rating on the stock.

SOTP valuation

Value of division	Rs/share	Notes
Cigarettes (A)	**140.0**	Based on DCF valuation
FMCG	10.8	2x FY12E sales to categories that have broken even, 1x FY12E to the other categories
Hotels	7.6	12x FY12E EV/EBITDA
Paper & Paperboards	9.6	5x FY12E EBITDA
Agribusiness	4.2	6x FY12E EBITDA
Cash and investment in subsidiaries	8.1	At current valuations
Total of the non-cigarettes business divisions (B)	**40.3**	
Total (A+B)	**180.3**	

PER Band



Source: B&K Research

Income Statement

Yr end 31 Mar (Rs mn)	FY09	FY10	FY11E	FY12E
Net sales	**156,119**	**181,532**	**210,471**	**240,961**
Growth (%)	*11.9*	*16.3*	*15.9*	*14.5*
Operating expenses	(107,082)	(120,315)	(137,952)	(157,073)
Operating profit	49,037	61,217	72,519	83,888
EBITDA	**49,037**	**61,217**	**72,519**	**83,888**
Growth (%)	*10.9*	*24.8*	*18.5*	*15.7*
Depreciation	(5,494)	(6,087)	(6,444)	(6,938)
Other income	4,897	5,556	6,124	6,852
EBIT	**48,441**	**60,687**	**72,198**	**83,802**
Interest paid	(183)	(534)	(283)	(285)
Pre-tax profit (before non-recurring)	48,257	60,153	71,916	83,517
Pre-tax profit (after non-recurring)	48,257	60,153	71,916	83,517
Tax (current + deferred)	(15,651)	(19,654)	(23,013)	(26,726)
Net profit (before Minority Interest, Pref. Dividend, etc.)	32,606	40,499	48,903	56,792
Prior period adjustments	30	111	0	0
Reported PAT	**32,636**	**40,610**	**48,903**	**56,792**
Adjusted net profit	**32,636**	**40,610**	**48,903**	**56,792**
Growth (%)	*4.6*	*24.4*	*20.4*	*16.1*

Balance Sheet

Yr end 31 Mar (Rs mn)	FY09	FY10	FY11E	FY12E
Cash and marketable sec.	29,765	54,963	52,783	73,905
Other current assets	71,287	70,008	79,016	88,740
Investments	8,923	13,569	13,569	13,569
Net fixed assets	84,860	91,514	99,219	106,594
Total assets	**194,835**	**230,053**	**244,586**	**282,808**
Current liabilities	47,036	80,482	66,941	77,365
Total debt	1,776	1,077	1,009	1,110
Other non-current liabilities	8,672	7,850	7,850	7,850
Total liabilities	**57,484**	**89,410**	**75,799**	**86,325**
Share capital	3,774	3,818	7,677	7,677
Reserves & surplus	133,576	136,826	161,109	188,805
Shareholders' funds	**137,351**	**140,644**	**168,786**	**196,483**
Total equity & liab.	**194,835**	**230,053**	**244,586**	**282,808**
Capital employed	**147,798**	**149,571**	**177,645**	**205,443**

Cash Flow Statement

Yr end 31 Mar (Rs mn)	FY09	FY10	FY11E	FY12E
Pre-tax profit	48,257	60,153	71,916	83,517
Depreciation	5,494	6,087	6,444	6,938
Change in working capital	(4,977)	6,541	(2,646)	(3,776)
Total tax paid	(12,444)	(20,476)	(23,013)	(26,726)
Other operating activities	30	111	0	0
Cash flow from oper. (a)	**36,361**	**52,416**	**52,701**	**59,954**
Capital expenditure	(16,862)	(12,041)	(14,150)	(14,313)
Change in investments	968	(28,891)	0	0
Others	(535)	(700)	0	0
Cash flow from inve. (b)	**(16,429)**	**(41,633)**	**(14,150)**	**(14,313)**
Free cash flow (a+b)	**19,931**	**10,784**	**38,552**	**45,641**
Equity raised/(repaid)	448	7,207	3,859	0
Debt raised/(repaid)	(369)	(698)	(68)	101
Dividend (incl. tax)	(15,432)	(16,339)	(44,523)	(24,619)
Others	30	(1)	0	0
Cash flow from fin. (c)	**(15,324)**	**(9,831)**	**(40,732)**	**(24,518)**
Net chg in cash (a+b+c)	**4,608**	**953**	**(2,180)**	**21,123**

Key Ratios

Yr end 31 Mar (%)	FY09	FY10	FY11E	FY12E
Adjusted EPS (Rs)	4.3	5.3	6.4	7.4
Growth	4.4	23.0	19.8	16.1
Book NAV/share (Rs)	18.1	18.3	21.9	25.5
Dividend/share (Rs)	1.9	5.0	2.8	3.3
Dividend payout ratio	50.1	109.6	50.3	51.2
Tax	32.4	32.7	32.0	32.0
EBITDA margin	31.4	33.7	34.5	34.8
EBIT margin	31.0	33.4	34.3	34.8
RoCE	35.1	40.8	44.1	43.8
Net debt/Equity	(20.4)	(38.3)	(30.7)	(37.0)

Valuations

Yr end 31 Mar (x)	FY09	FY10	FY11E	FY12E
PER	38.7	31.5	26.3	22.6
PCE	33.1	27.4	23.2	20.2
Price/Book	9.2	9.1	7.6	6.6
Yield (%)	1.1	3.0	1.6	1.9
EV/Net sales	7.9	6.8	5.9	5.1
EV/EBITDA	25.2	20.2	17.0	14.7

Du Pont Analysis – ROE

Yr end 31 Mar (x)	FY09	FY10	FY11E	FY12E
Net margin (%)	20.9	22.4	23.2	23.6
Asset turnover	0.9	0.9	0.9	0.9
Leverage factor	1.4	1.5	1.5	1.4
Return on equity (%)	25.3	29.2	31.6	31.1

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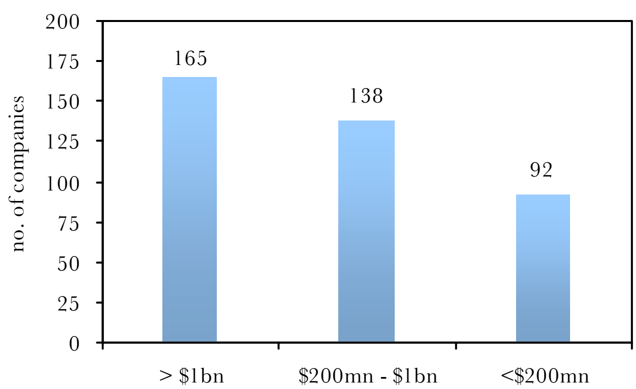
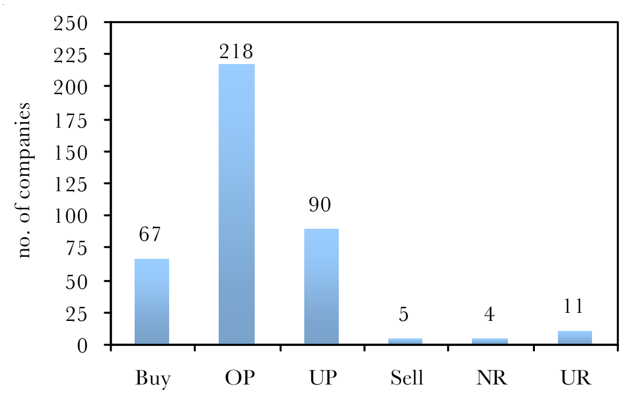
Analyst Declaration: We, Harit Kapoor & Ashit Desai, hereby certify that the views expressed in this report accurately reflect our personal views about the subject securities and issuers. We also certify that no part of our compensation was, is, or will be, directly or indirectly, related to the specific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

B&K Universe Profile

By Market Cap (US$ mn)



By Recommendation



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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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