Q4FY09 Result Update

May 27, 2009

After recommending investors to exit ITC in our Q1FY09 result review, we advised them to re-enter the stock in our Q3FY09 results update dated January 29, 2009, in the price band of Rs. 149-158 for a price target of Rs. 184. Subsequently, the stock entered our price band, touching a low of Rs. 155.8 on March 09, 2009 & thereafter it made a high of Rs. 207.5 on May 04, 2009, thus achieving our price target. Currently, the stock is quoting at Rs. 183.85.

We present an update on the stock after the Q4FY09 results:

Q4FY09 Results Review

- ITC's Q4FY09 results were disappointing & not in line with our estimations. The Net Sales declined by 1.1% in Q4FY09 to Rs. 38.9 bn as against Rs. 39.3 bn in Q4FY08 on account of poor performance from Agri & Hotels business in revenue terms. However, the operating profit grew by 20.9% on account of decline in the total expenditure by 9% during the quarter. The total expenditure as a % to sales reduced from 73.4% in Q4FY08 to 67.6% in Q4FY09. Operating profit margins improved significantly by 580 bps to 32.4%. However, other income reduced by 46.3% from Rs. 1636.8 mn in Q4FY08 to Rs. 878.5 mn in Q4FY09. This coupled with higher depreciation (which increased by 19.4%) & interest cost (which increased by 406.7% from Rs. 27 mn to Rs. 136.8 mn) during the quarter impacted the PAT growth. PAT increased by only 10% in Q4FY09 (Y-o-Y). PAT margins improved from 18.7% in Q4FY08 to 20.8% in Q4FY09. PBIT margins improved substantially from 26.8% in Q4FY08 to 31.9% in Q4FY09, due to higher EBIT reported by Cigarettes & Agri business in segment. The Board of Directors recommended a dividend of Rs. 3.70 per share of Re.1/- each (FY08: Rs. 3.50 per share).

- New FMCG segment's revenues grew by 13.5%. However, the segment continued to report PBIT loss of Rs. 1172.8 mn, which reduced only marginally by 0.5% over corresponding quarter of previous year. This was mainly due to continuing impact of high commodity prices and store rentals & higher brand building costs of the new Personal Care portfolio. The Hotel revenues declined by 29.3%, while its PBIT fell sharply by 50.2% on account of economic slowdown and the unfortunate terror strikes in Mumbai in November 2008. Cigarettes & Paper Boards, Paper & Packaging business continued to do well on both revenue & EBIT front. Cigarettes business net revenues increased by 16.3% over Q4FY08, while the net sales of Paper & Packaging business went up by 25.7%. However, on a Q-o-Q basis, the cigarettes business grew by only 0.9%, while the Paper & Packaging revenues increased by 13.8%.

	Gross Revenue (Rs. in Mn)		% Y-o-Y Growth	Net Revenue (Rs. in Mn)		% Y-o-Y Growth	EBIT Margins (%)		Change in bps
	Q4FY09	Q4FY08		Q4FY09	Q4FY08		Q4FY09	Q4FY08	
FMCG - cigarettes	39492.6	35830	10.2	20115.4	17302.3	16.3	53.8	50.3	350
FMCG - others	8388.3	7384.3	13.6	8368.0	7372.6	13.5	-14.0	-16.0	200
Hotels	2413.4	3392.8	-28.9	2210.3	3125.4	-29.3	32.2	45.7	-1350
Agri-business	5258.9	10781.1	-51.2	5258.9	10781.1	-51.2	10.1	3.4	670
Paperboards, paper & packaging	7470.3	6196.7	20.6	7136.3	5677.1	25.7	21.3	21.6	-30

(Source: Company)

Cigarettes Business - Continues to perform well

In Q4FY09, cigarette revenues (gross) increased by 10.2% (Y-o-Y). However, cigarette volumes declined 3-3.5% (Y-o-Y), which was in line with similar decline in Q3FY09. This was mainly due to high base effect. Cigarette volume growth in Q4FY08 (Y-o-Y) was robust at ~2% as the company sold out inventory of non-filter cigarettes after the budget announcement of 140-390% increases in excise tax on non-filter cigarettes. However, the filters segment reported volume growth of 18% during the quarter (Y-o-Y).

The EBIT margins (at gross level) expanded by 310bps over Q4FY08 to 27.4%. This was on account of price hikes taken over the past year and the improvement in mix as non-filter cigarettes were discontinued this year. The net revenues of cigarettes business grew by 16.3%, with the EBIT margins (as a percentage to net sales) improving by 350 bps from 50.3% in Q4FY08 to 53.8% in Q4FY09.

ITC has taken further price hikes in April in 'Gold Flake Filter Kings', which contributes by 10%, which will help the company expand cigarette margins over the quarters ahead. FY10 volume growth in cigarettes will depend largely on the excise duty hike that the government eventually imposes in the upcoming budget.

Non Cigarette FMCG business

The non-cigarette FMCG businesses reported growth of 13.5% to Rs. 7.2 bn, while PBIT losses reduced only marginally by 0.5% to Rs. 1173 mn (Rs. 1178 mn in Q4FY08). The company continues its focus on profitability in its core foods business comprising biscuits and branded staples. The slowdown in discretionary apparels has also been hit by the economic slowdown. Going forward, we expect the losses to reduce further under this segment as the lower raw material prices start factoring in from Q1FY10.

The **Branded Packaged Foods** clocked reasonable growth during the year despite weak demand in certain categories in the face of the economic slowdown. Margins during the year were adversely impacted due to the simultaneous increase in the prices of input commodities including fuel. The business is energetically focussing on driving consumer franchise, consolidating the portfolio in select high margin categories, improving market servicing and driving supply chain efficiencies. The 'Bingo!' range of Finger snacks was augmented during the year with the launch of 'Hatke Jhatke', a wave shaped snack in two exciting flavours. The biscuits business continued on its growth trajectory with sales improving by 14% during the year. The 'Sunfeast' range of biscuits witnessed continued enrichment in product mix with higher sales of value added products like Creams, Cookies etc. In the Staples business, 'Aashirvaad' atta continued its leadership position with a market share of 54% among branded national players.

The **Lifestyle Retailing Business** achieved a robust growth of 32% in exports despite tough economic conditions in the target US and European markets. The growth was driven by improved product mix through the offer of high value embellished garments and addition of premium fashion customers. The business has consolidated its market presence by establishing 'Wills Lifestyle ' as a vibrant lifestyle brand and 'John Players' as a leading fashion brand for the youth. However, the recent economic slowdown and weak consumer sentiment have adversely affected the growth of 'John Players' in the mid segment. The business is actively engaged in renegotiation of rentals, closing down of unviable stores and implementing a series of cost management measures to boost retail and supply chain productivity.

The **Personal Care Business** augmented the 'Vivel' range of hair care products with the launch of 'Vivel Ultra Pro', an offering in the anti dandruff category. The business's suite of brands, 'Fiama Di Wills', 'Vivel Di Wills', 'Vivel' and 'Superia' continue to address identified segments of the market with differentiated value offerings. However, increase in the raw material cost & higher ad spends has impacted the operating performance of this division. The Business made significant investments in products and brands to gain wider consumer acceptance. Product development and research are being leveraged in a focused manner to build brand equity. Accretion to tax exempt manufacturing capacities will provide benefits of assured quality, flexibility and cost advantages.

The **Stationery Business** witnessed strong growth of 60% during the quarter, positioning the Company as the largest marketer of notebooks in India. Its two flagship brands, namely 'Classmate' for the student community and 'Paperkraft' for the discerning working executives have established a strong presence in the Indian stationery market in a short span of time. The business recently launched the 'Paperkraft Premium Business Paper', an eco-friendly "green" paper with a higher archival life.

Hotels

The Hotels business of ITC got severely impacted in FY09 as a result of economic slowdown and the terrible terror strikes at Mumbai. The squeeze on corporate travel along with the steep reduction in foreign arrivals have triggered a significant slide in occupancies and average room rates for the hotel sector in India. The situation after the terror strikes got aggravated in the Q4FY09 with adverse travel advisories issued by most source countries. The net revenues of this segment declined by 29.3%, while the EBIT declined substantially by 50.2% from Rs. 1427.6 mn in Q4FY08 to Rs. 711 mn in Q4FY09. The outlook on this segment remains grim, as there is unlikely to be any significant improvement in tourism & businesses continue to reduce spends on travel at least in H1FY10. Q1FY10 could witness a steeper fall because of base effect, as Q1FY09 had recorded high sales, with ITC being the official host for the Indian Premier League cricket tournament.

Considering India's inadequate room capacity, the business is pursuing an aggressive investment led growth strategy. Construction activity in respect of the super deluxe luxury hotel projects at Bangalore and Chennai is progressing satisfactorily as per the respective project plans.

Paperboards, Speciality paper and Packaging

The business maintained its market leadership with segment net revenues increasing by 25.7% (Y-o-Y). However, EBIT margins declined 30 bps from 21.6% in Q4FY08 to 21.3% in Q4FY09. However, on Q-o-Q basis, the margins improved by 360 bps, reflecting the production ramp-up at the new pulp and paperboard facilities, which started operations three quarters ago.

The Packaging and Printing business is consolidating the investments made in world-class technology to provide cost effective and superior packaging solutions to a wide range of customers including strategic sourcing support to the Company's Cigarette and other FMCG businesses. The investments in backward integration of the flexibles platform will drive cost competitiveness and widen packaging options for in-house requirements and key customers in the external trade.

Agri-business

Agri sales declined by 51.2% (Y-o-Y), as the company rationalized soya and other low-margin agri exports, in view of increasing policy interventions and high volatility in prices. However, due to strong improvement in margins of leaf tobacco exports, EBIT grew by 43.4% (Y-o-Y), with margins improving significantly from 3.4% in Q4FY08 to 10.1% in Q4FY09, reaching the highest level in the last 17 quarters.

Conclusion & Recommendation:

ITC's FY09 numbers were marginally below our estimations. In our Q3FY09 results update, we had downgraded our FY09 EPS estimates from Rs. 9.3 to Rs. 8.7 on concerns over its Non-cigarette FMCG & Hotels business. The company reported an EPS of Rs. 8.6. Its net sales & PAT grew by 10.3% & 4.6% respectively over FY08. The operating margins stayed flat, while the PAT margins declined from 22.4% in FY08 to 21.2% in FY09. ITC's Cigarette business continued to perform well due to its strong brands & extensive distribution network. The cigarettes net sales increased by 13.9%, while its EBIT went up by 15.1%. We expect this business to be largely resilient & hence support healthy profit and cash flow growth. Volume growth however could continue to be difficult to achieve unless the excise rates do not rise in the next Budget.

ITC's non-cigarette FMCG business continues to disappoint on profitability terms. Although the revenues grew by 19.8%, the segment's PBIT losses increased significantly by 83.5% over FY08. In Q4FY09, the company was able to trim the losses only marginally by 0.5% (Y-o-Y). Being a new entrant in the non-cigarette FMCG business, ITC has no pricing power. With cutthroat competition from other established FMCG players & higher advertising cost, the FMCG business could continue to report loss over the next few quarters. However, recent decline in the raw material prices would start factoring it from Q1FY10, which could trim down the losses this fiscal.

Declining occupancy rates & ARRs could continue to impact the performance of Hotel segment. Q1FY10 could witness a steeper fall in segment profits due to the Indian premier league played out of India this year. Last year, in Q1FY09, the segment reported higher sales as a result of IPL played in India. However, there could be a rapid turnaround in the performance of this segment in H2FY10 on the economic revival. The Paper segment has done reasonably well as the net sales & EBIT have increased by 22.7% & 12.2% respectively over FY08. However, the EBIT growth was lower than in line with sales due to rising input cost & high depreciation during the year. The recently commissioned 1 lac TPA paper machine has reached optimum levels of output at the desired quality and is geared to service the growing demand for value added printing and writing paper.

International Cigarette companies generally quote at P/E of 12-13, while their revenues are expected to grow at about 4% and PAT at about 5%. Indian market offers better scope in terms of likely increase in volume growth due to demographic factors and also due to the absence of consumer litigation in India. While the volume growth numbers for ITC are not exciting so far, value growth has so far been driven by price hikes and uptrading to filter segments. Hence one can give ITC's cigarette business a higher valuation than that commanded by its global peers. Further scarcity of large defensive FMCG plays in India could result in some more premium valuation for ITC. However, 80% of Capital employed is invested in asset-backed segments that typically get lower valuations.

In FY10, we feel that ITC could deliver Net Sales of Rs. 174.6 bn & PAT of Rs. 37.4 bn, resulting in an EPS of Rs. 9.9. At CMP of Rs. 183.85, the stock is trading at 18.6xFY10E EPS. We recommend investors to book profits at current levels. Fresh entry could be made on declines in the price band of Rs. 160-165 for a target of Rs. 195.

Quarterly Financials:

(Rs. in Million)

Particulars	Q4FY09	Q4FY08	VAR [%]	Q3FY09	VAR [%] (Q-o-Q)	Q3FY08	VAR [%] (Y-o-Y)	Q2FY09	Q2FY08	VAR [%]	Q1FY09
Net Sales	**38918.1**	**39343.9**	**-1.1**	**38586.5**	**0.9**	**34579.9**	**11.6**	**38626.7**	**32701.4**	**18.1**	**38997.0**
Other Income	878.5	1636.8	-46.3	975.6	-10.0	1374.0	-29.0	1104.5	2082.5	-47.0	1143.5
Total Income	39796.6	40980.7	-2.9	39562.1	0.6	35953.9	10.0	39731.2	34783.9	14.2	40140.5
Raw Material Consumed	12452.5	13224.0	-5.8	12983.9	-4.1	11600.1	11.9	14359.4	10979.3	30.8	13362.0
Stock Adjustment	809.5	530.5	52.6	-480.3	-268.5	-737.0	-34.8	-1082.4	158.8	-781.6	-483.7
Finished Goods Purchased	2515.0	4690.1	-46.4	2667.3	-5.7	2266.4	17.7	2207.3	3424.6	-35.5	5157.3
Employee Expenses	2221.5	1910.7	16.3	2129.5	4.3	1906.4	11.7	2376.7	1750.6	35.8	2181.1
Other Expenses	8292.5	8541.9	-2.9	7505.7	10.5	7458.6	0.6	8611.8	6068.2	41.9	7509.1
Total Expenditure	**26291.0**	**28897.2**	**-9.0**	**24806.1**	**6.0**	**22582.7**	**9.8**	**26472.8**	**22381.5**	**18.3**	**27725.8**
PBIDT	**13505.6**	**12083.5**	**11.8**	**14756.0**	**-8.5**	**13371.2**	**10.4**	**13258.4**	**12402.4**	**6.9**	**12414.7**
Interest	136.8	27.0	406.7	4.5	2940.0	18.3	-75.4	27.8	9.1	205.5	14.1
PBDT	13368.8	12056.5	10.9	14751.5	-9.4	13352.9	10.5	13230.6	12393.3	6.8	12400.6
Depreciation	1451.1	1214.9	19.4	1442.0	0.6	1097.4	31.4	1339.9	1062.0	26.2	1261.1
PBT	11917.7	10841.6	9.9	13309.5	-10.5	12255.5	8.6	11890.7	11331.3	4.9	11139.5
Tax (incl. FBT & DT)	3827.8	3485.2	9.8	4277.4	-10.5	3948.3	8.3	3863.5	3622.6	6.6	3652.8
PAT	**8089.9**	**7356.4**	**10.0**	**9032.1**	**-10.4**	**8307.2**	**8.7**	**8027.2**	**7708.7**	**4.1**	**7486.7**
EPS	**2.1**	**2.0**	**9.8**	**2.4**	**-10.5**	**2.2**	**8.6**	**2.1**	**2.0**	**4.0**	**2.0**
Equity	3774.4	3768.6	0.2	3771.5	0.1	3765.8	0.2	3770.2	3763.9	0.2	3768.6
Face Value	1	1.0	0.0	1.0	0.0	1.0	0.0	1.0	1.0	0.0	1.0
PBIDTM (%)	**32.4**	**26.6**	**22.2**	**35.7**	**-9.1**	**34.7**	**2.9**	**31.5**	**31.6**	**-0.3**	**28.9**
PATM (%)	**20.8**	**18.7**	**11.2**	**23.4**	**-11.2**	**24.0**	**-2.6**	**20.8**	**23.6**	**-11.8**	**19.2**

(Source: Company)

Segmental Results:

(Rs. in Million)

Particulars	Q4FY09	Q4FY08	VAR [%]	Q3FY09	VAR [%]
Revenue (Net)					
FMCG Cigarettes	20115.4	17302.3	16.3	19935.4	0.9
FMCG Others	8368	7372.6	13.5	7200.0	16.2
Paper Boards, Paper & Packaging	7136.3	5677.1	25.7	6270.9	13.8
Agri Business	5258.9	10781.1	-51.2	6215.1	-15.4
Hotels	2210.3	3125.4	-29.3	2471.2	-10.6
Total	**43088.9**	**44258.5**	**-2.6**	**42092.6**	**2.4**
Less: Inter Segment Revenue	-4170.8	-4914.6	-15.1	-3759.5	10.9
Net sales/income from Operations	**38918.1**	**39343.9**	**-1.1**	**38333.1**	**1.5**
Segment Results					
FMCG Cigarettes	10813.5	8700.6	24.3	11341.4	-4.7
FMCG Others	-1172.8	-1178.9	-0.5	-1270.1	-7.7
Paper Boards, Paper & Packaging	1519.1	1227.2	23.8	1110.5	36.8
Agri Business	530.6	370.1	43.4	501.8	5.7
Hotels	711	1427.6	-50.2	910.7	-21.9
Total	12401.4	10546.6	17.6	12594.3	-1.5
Interest	-136.8	-27.0	406.7	-4.5	2940.0
Other un-allocable expenditure net off un-allocable income	-346.9	322.0	-207.7	719.7	-148.2
Total Profit Before Tax	**11917.7**	**10841.6**	**9.9**	**13309.5**	**-10.5**
Capital Employed					
FMCG Cigarettes	30765.5	23146.4	32.9	28793.9	6.8
FMCG Others	20866.3	18266.6	14.2	23212.7	-10.1
Paper Boards, Paper & Packaging	37711.5	32641.8	15.5	38022.7	-0.8
Agri Business	10383.2	14689.7	-29.3	8354.7	24.3
Hotels	21888.9	18653.2	17.3	20698.4	5.8
Total Capital Employed	**121615.4**	**107397.7**	**13.2**	**119082.4**	**2.1**

(Source: Company)

Financial Estimations:

(Rs. in Million)

Particulars	FY08	FY09	FY10*
Net Sales	139475.3	153881.1	174630.0
PBIDT (excl. other income)	44039.4	48585.4	54833.8
Net Profit	31201.0	32635.9	37366.6
Equity	3768.6	3774.4	3774.4
EPS (Rs.)	8.3	8.6	9.9
PBIDTM (%)	31.6	31.6	31.4
PATM (%)	22.4	21.2	21.4

*Quick Estimates

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