

JUNE 28, 2011
UPDATE

Coverage view: **Cautious**

Price (Rs): **194**

Target price (Rs): **230**

BSE-30: **18,492**

Some topical issues surrounding ITC cigarettes. (1) Harsh set of graphic warnings on cigarette packs in US to be implemented w.e.f. September 2012, (2) Australia could set a precedent in stricter norms for cigarette packaging (proposal for plain packaging), (3) request from Kerala Chief Minister to Prime Minister to ban tobacco usage. We are not worried on the likely introduction of new pictorial warnings in India w.e.f. December 2011 as ~70% of cigarette sales are in single sticks. Moreover, cigarette taxation is important for government finances (~8% of central excise collection). Earnings visibility, increasing RoEs and potential for increase in payout are positives. ADD.

Company data and valuation summary

ITC				Forecasts/Valuations				
Stock data		2011	2012E	2013E				
52-week range (Rs) (high,low)	197-132	6.5	8.0	9.1				
Market Cap. (Rs bn)	1,501.7	22.1	23.1	13.5				
Shareholding pattern (%)				P/E (X)	30.1	24.5	21.5	
Promoters	0.0	211.7	248.3	286.8				
FIs	14.4	49.9	61.4	69.7				
MFs	3.1	74.5	92.5	105.6				
Price performance (%)		1M	3M	12M	EV/EBITDA (X)	19.6	15.7	13.6
Absolute		4.1	10.9	30.6	ROE (%)	34.3	37.3	36.2
Rel. to BSE-30		4.3	14.4	25.8	Div. Yield (%)	2.3	1.9	2.3

Some global and national developments—and their likely impact on cigarette smoking / ITC

- ▶ **New set of graphic warnings on cigarette packs in US from September 2012.** The US Department of Health and Human Services recently released new set of pictorial warnings that would be put on cigarette packs from September 2012. These pictures are harsher and would potentially cover upper half of the front and back of the cigarette pack as well as 20% of the space in cigarette advertisements.

The pictorial warnings in India today are relatively benign and new set of graphics are slated to be issued from December 2011. While this could be perceived as incrementally negative, we are not worried as ~70% of cigarette sales in India still continue to be in single sticks (limited exposure of the pack to the smoker).
- ▶ **Proposal for plain packaging for cigarettes in Australia.** Media reports suggest that Australia is likely to introduce plain packaging for cigarettes in 2012 (continuation of the implementation of WHO rules on tobacco regulation). While this is likely to be contested by tobacco companies, we believe that even if a diluted version of this gets implemented, it will set a precedent globally and put pressure on other governments (including India) to endorse it given the negative social connotations attached with cigarette smoking.
- ▶ **Request from Kerala Chief Minister to Prime Minister to ban tobacco usage.** The recent request from the Kerala CM to ban tobacco usage nationally is incrementally worrying; however, in our view, implementation of the same is difficult given the significant contribution made by cigarettes towards excise collection (~8% of central excise collection and ~10% of Kerala State sales tax collection). If a state-level ban is issued (a la liquor ban in Gujarat), it would be significantly negative for ITC as Kerala contributes ~12% of its overall sales. However, we highlight that even an implementation of ban on public smoking has not been effective in most states.

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Retain ADD; earnings visibility and potential for increase in payout are positives

We retain earnings estimates (EPS of Rs8 and Rs9.1 for FY2012E and FY2013E, respectively); maintain ADD rating and TP of Rs230. We model cigarette volume growth of 5% and 4% in FY2012E and FY2013E, respectively. We also expect break-even in 'Other FMCG' business in FY2013E. We value ITC on P/E (25X) as our underlying themes on ITC are intact, (1) strong EPS CAGR of ~18% over FY2011-13E, (2) sustaining strong trends in cigarettes, (3) likely improvement in RoCE and (4) higher dividend payout.

Key risks are (1) unexpected higher losses in other FMCG, and (2) any aggressive marketing strategy (including trade discounting) by Philip Morris to promote Marlboro.

New graphic warnings on cigarette packs to be released in US from September 2012



Source: Media reports, Kotak Institutional Equities

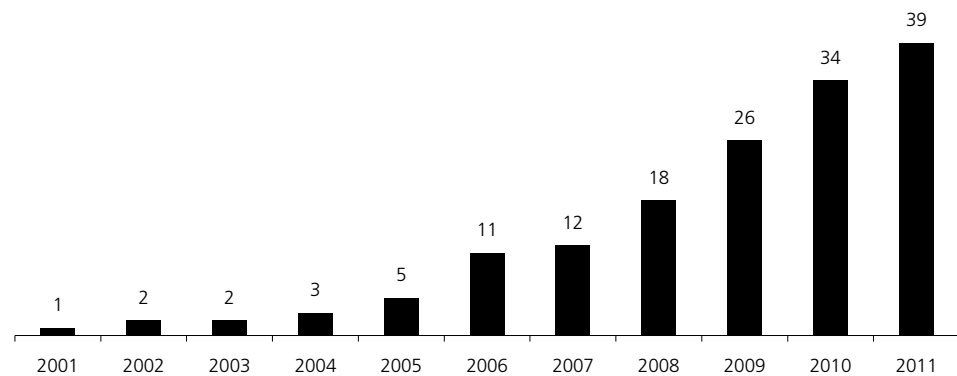
Current pictorial warnings on cigarette packs in India



Source: Media reports, Kotak Institutional Equities

Pictorials are more of a recent phenomenon

Countries requiring pictorial warnings on cigarette packs



Source: Canadian Cancer Society, Kotak Institutional Equities

Kerala is one of the highest contributors to ITC's sales

Break-up of ITC's sales by states

State/region	Contribution to ITC cigarette sales (Value, %)
Andhra Pradesh	13
Kerala	12
Tamilnadu	11
Karnataka	9
Maharashtra	9
West Bengal	8
Haryana	4
Uttar Pradesh	4
Bihar	3
Chattisgarh	3
Gujarat	3
Madhya Pradesh	3
Rajasthan	3
Himachal Pradesh	2

Source: Kotak Institutional Equities estimates

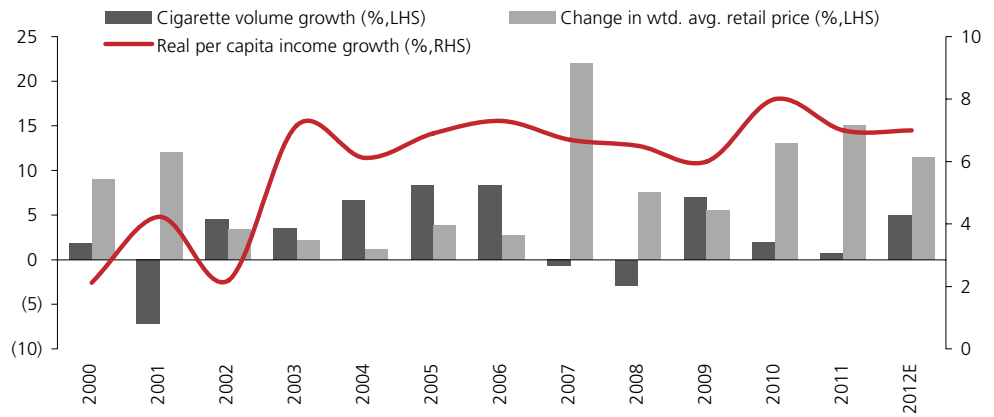
Gujarat, HP, Bihar and Rajasthan have hiked VAT on cigarettes

State/region	Current VAT on cigarettes	Whether budget presented or not	
		Yes / No	Any recent change in VAT
Andhra Pradesh	12.5	Yes	No
Bihar	13.5	Yes	Yes, increased from 12.5%
Chattisgarh	12.5	Yes	No
Gujarat	25.0	Yes	Yes, increased from 20%
Haryana	20.0	Yes	No
Himachal Pradesh	16.0	Yes	Yes, increased from 13.75%
Karnataka	15.0	Yes	No
Kerala	12.5	No	No
Madhya Pradesh	12.5	Yes	No
Maharashtra	20.0	Yes	No
Rajasthan	40.0	Yes	Yes, increased from 20%
Tamilnadu	12.5	No	No
Uttar Pradesh	13.5	Yes	No
West Bengal	12.5	No	No

Source: Kotak Institutional Equities

Cigarette volumes have remained resilient

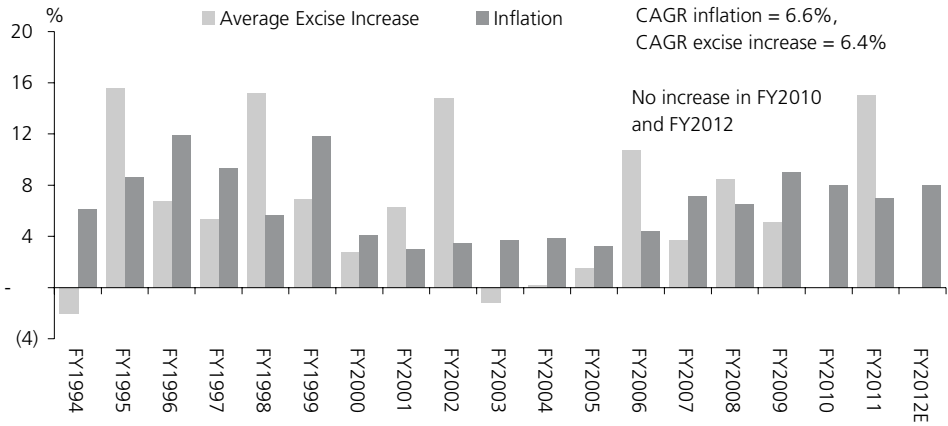
Cigarette volumes growth, average retail price increase and real per capita income growth (%)



Source: Kotak Institutional Equities estimates

CAGR excise increase is in line with inflation of 6% suggesting a rational approach to cigarette taxation

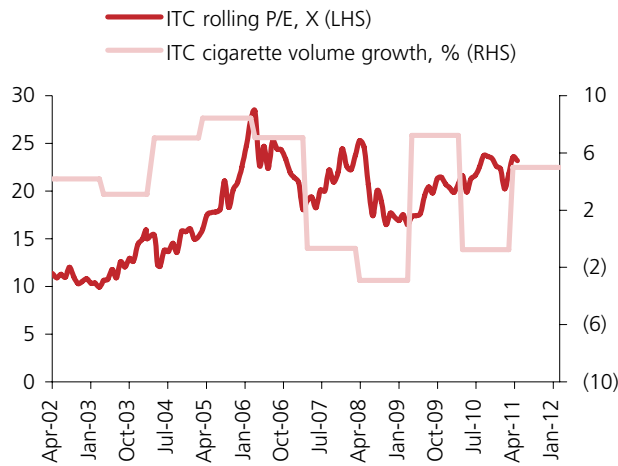
Average excise increase and inflation for FY1994-2012E (%)



Source: Kotak Institutional Equities

Cigarette volume growth is key

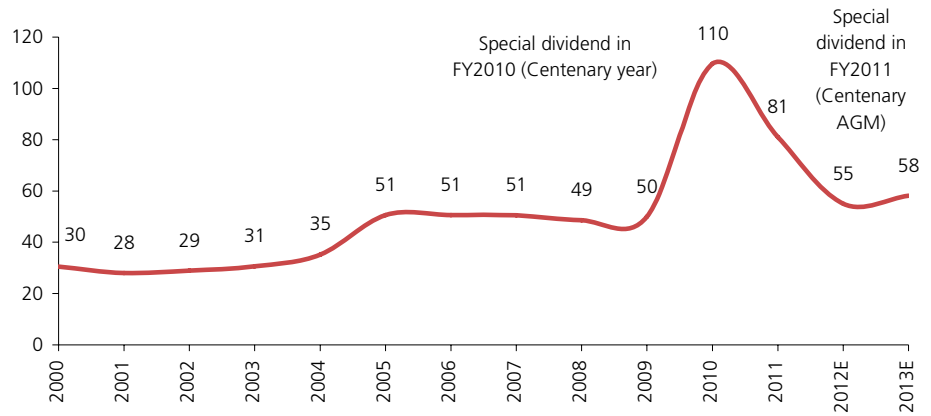
ITC PE, X (RHS) and ITC cigarette volume growth, % (RHS)



Source: Kotak Institutional Equities estimates

Dividend payout could potentially increase

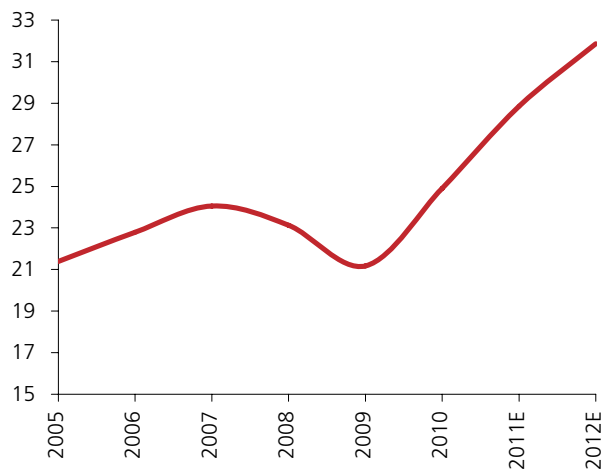
Dividend payout ratio, March fiscal year-ends, 2000-2013E (%)



Source: Kotak Institutional Equities estimates

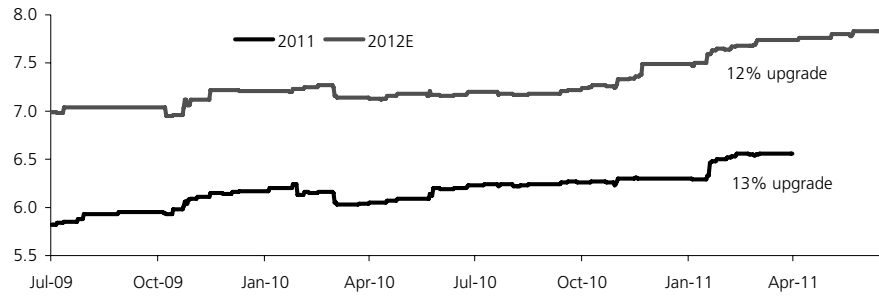
Improving ROCE levels

ROCE, March fiscal year-ends, 2005 - 2012E (%)



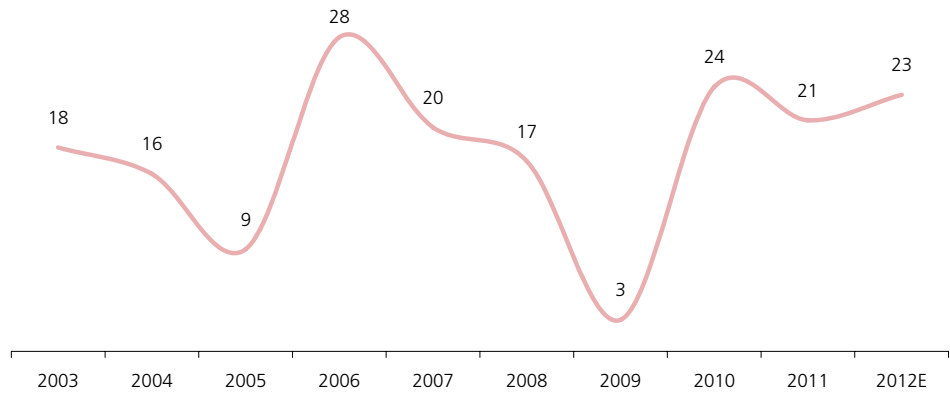
Source: Kotak Institutional Equities estimates

ITC's earnings witnessed significant upgrades in FY2010-12E
 Consensus EPS estimates, March fiscal year-ends, 2010-12E (Rs)



Source: Bloomberg

Limited potential for earnings upgrades in FY2012E
 ITC's earnings growth, March fiscal year-ends, 2003 - 2012E (%)



Source: Company, Kotak Institutional Equities estimates

ITC: Profit model, balance sheet, cash flow model 2007-2014E, March fiscal year-ends (Rs mn)

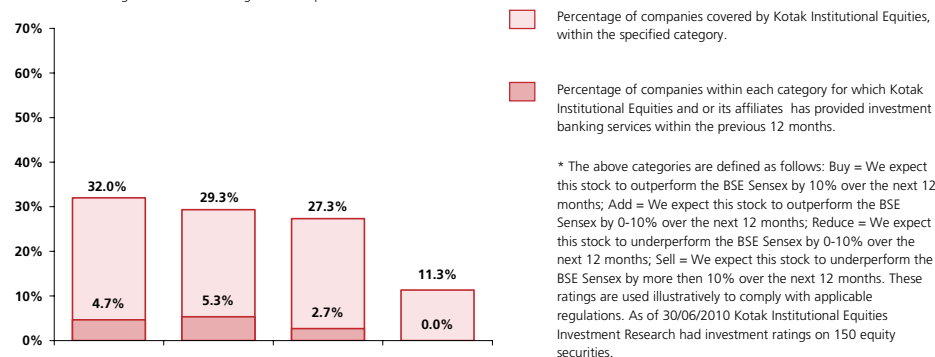
	2007	2008	2009	2010	2011E	2012E	2013E	2014E
Profit model (Rs mn)								
Net sales	123,693	140,012	156,119	181,532	211,676	248,306	286,779	329,363
EBITDA	39,700	44,703	48,686	60,936	71,534	87,805	99,836	116,917
Other income	3,365	6,109	5,349	6,034	8,188	9,576	10,956	12,411
Interest	(169)	(173)	(284)	(730)	(481)	(592)	(590)	(587)
Depreciation	(3,629)	(4,385)	(5,494)	(6,087)	(6,560)	(7,398)	(8,180)	(9,040)
Pretax profits	39,267	46,255	48,258	60,153	72,682	89,391	102,023	119,702
Tax	(12,267)	(14,517)	(15,622)	(19,543)	(22,806)	(28,001)	(32,325)	(37,889)
Net profits	27,000	31,738	32,636	40,610	49,876	61,390	69,697	81,813
Earnings per share (Rs)	3.6	4.2	4.3	5.4	6.5	8.0	9.1	10.6
Balance sheet (Rs mn)								
Total equity	104,371	120,577	137,351	140,644	150,564	178,185	207,358	261,570
Deferred taxation liability	4,729	5,451	8,672	7,850	7,850	7,850	7,850	7,850
Total borrowings	2,009	2,144	1,776	1,077	1,077	1,077	1,077	1,077
Current liabilities	38,576	44,323	47,036	80,482	71,402	69,867	76,890	79,397
Total liabilities and equity	149,684	172,495	194,835	230,053	230,893	256,979	293,176	349,894
Cash	9,002	5,703	10,310	11,263	6,023	13,931	31,239	69,248
Current assets	53,896	64,490	71,287	70,008	67,714	78,300	90,379	100,138
Total fixed assets	56,109	72,956	84,860	91,514	99,887	107,479	114,289	123,239
Investments	30,678	29,346	28,378	57,269	57,269	57,269	57,269	57,269
Total assets	149,684	172,495	194,834	230,053	230,893	256,979	293,176	349,894
Free cash flow (Rs mn)								
Operating cash flow	31,040	37,112	41,493	49,850	57,561	70,484	79,290	92,668
Working capital	(8,667)	(6,634)	(4,991)	6,541	5,951	(4,001)	(4,292)	(2,643)
Capital expenditure	(15,702)	(21,239)	(17,407)	(12,751)	(14,943)	(15,000)	(15,000)	(18,000)
Free cash flow	6,672	9,238	19,095	43,640	48,570	51,484	59,998	72,025
Key ratios (%)								
Sales growth	26.3	13.2	11.5	16.3	16.6	17.3	15.5	14.8
EBITDA margin	32.1	31.9	31.2	33.6	33.8	35.4	34.8	35.5
EPS growth	20.1	17.1	2.8	23.8	20.8	23.1	13.5	17.4

Source: Kotak Institutional Equities estimates

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Source: Kotak Institutional Equities

As of June 30, 2010

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