Equitymaster Agora Research Private Limited
Independent Investment Research
6 September, 2008

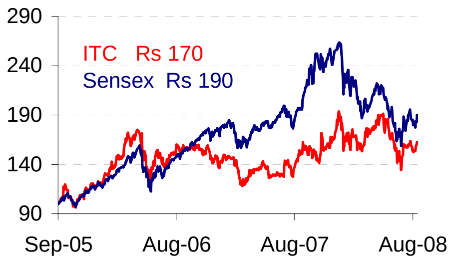
ITC Limited

Sell

Market data

Current price	Rs 189 (BSE)
Market cap	Rs 713,208 m
Face value	Re 1.0
FY08 DPS (Rs)	3.5
BSE Code	500875
NSE symbol	ITC
No. of shares	3768.6 m
Free float	100.0%
52 week H/L	Rs 239/158

Rs 100 invested is now worth



Stock price Performance

	ITC	Index*
1-yr	11.8%	-2.4%
2-yr	1.2%	13.0%
3-yr	17.6%	23.8%

Returns are on compounded basis
*BSE Sensex

Shareholding (June-2008)

Category	(%)
Promoters	0.0
Banks, MFs & UTI	38.3
FIIs	13.5
Public	12.2
Others	36.1
Total	100.0

Report prepared by

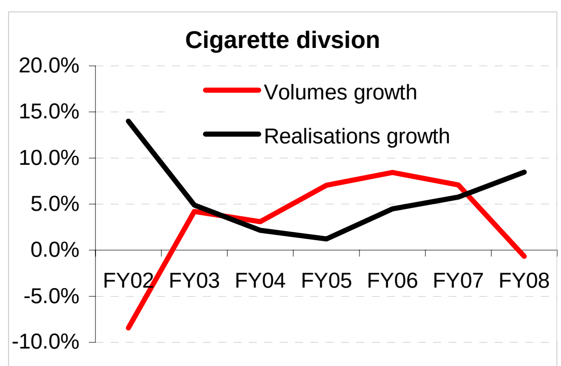
Equitymaster Agora Research Private Limited.
www.equitymaster.com
info@equitymaster.com

Investment Concerns

- **An unfavorable risk reward equation:** Up until now, we liked the company's strategy of using excess cash flows from its hugely profitable but controversial business of tobacco products to fund its other business segments like hotels and food and at the same time bring them up to scale. The idea seemed to be working, as although cigarettes still account for more than 58% of the company's total revenues, its contribution had indeed come down. However, that trickle of cash infusion is likely to turn into a torrent, as ITC has embarked upon one of its biggest capex plans to date, where it plans to invest a whopping Rs 200 bn towards its various businesses over a period of five years starting FY08. Since the returns from this capex are not likely to start accruing to the company immediately, our projections point towards a negative free cash flow (after accounting for capex) scenario for the company from a medium term perspective. Taking this and the current stretched valuations into account, we believe the risk-reward ratio is skewed towards the former and hence our negative outlook towards the stock over the medium term.

- **Concerns on cigarette division:** With steep increase in the excise duty for non-filter cigarettes, ITC has pulled itself out of this segment. It accounted for ~20% of its total volumes in FY08. The cigarette business however, reported better than expected numbers in 1QFY09 with volumes declining by only 3%. According to the company, there has been ~80% migration from plains (unfiltered cigarettes) to filtered cigarettes, which is a positive. Though the company raised prices of select brands by as much as 10% to 30% to offset rising cost of tobacco, paper and other inputs, we believe that there are several long-term concerns that would continue to pose a problem for the company's core business.

  - **Increasing competition:** Cigarettes business has high price inelasticity. ITC has been able to pass on the burden of high taxes through price hikes in the past. However, in the recent Union budget, government increased the excise duty on non-f ilter cigarettes, thus making non-filters business an unviable business proposition. An



upward shift would benefit ITC as it accounts for ¾th of the filter market. However, the opportunity to convert the remaining 86% of the tobacco consumers (around 48% is in the form of chewing tobacco, 38% as bidis) into cigarette users will be difficult as the gap between bidi and filter cigarette is substantial (about 10 times). Further with non-filter cigarettes becoming unviable, smuggled and tax-evaded cigarettes, as per the company, are capturing its market. It claimed that consequent to the 30% equivalent increase in tax rates on cigarettes during the year, the volume of these illegal products has doubled fromaround 150 m per month to nearly 300 m. Also over the last few months, several contra band low cost filter cigarette brands have witnessed a rapid volume growth and now account for ~5% of industry volumes. According to industry estimates, cigarette grey market has grown by over 25% to Rs 18 bn in the last six months alone as against Rs 14 bn last year. These contraband cigarettes could be a big threat in the coming months.

- **Higher tobacco prices:** The average price of the premier grade used for cigarette making, flue cured virginia (FCV), has risen to Rs 85 per kg from Rs 47 a year ago. The global shortfall in tobacco output has boosted demand for the Indian leaf, pushing up prices in the domestic market to new records, thus hurting Indian cigarette makers. Further jump in the prices could hurt margins in the cigarette business.

- **Regulatory pressure:** Government has become very aggressive in targeting the tobacco consumption, specially smoking. It also raised the taxes on the non-filter cigarettes to bring it on par with the filter cigarettes. Post the price increases, non-viability of the non-filtered segment has forced major cigarettes manufacturer to withdraw from non-filter segments. Increasing taxes, ban of smoking in public place and pictorial warnings would hurt the long-term growth prospects of the company

- **Losses in new ventures:** The company reported a loss of Rs 1.2 bn in the non-FMCG division (specially in the foods and personal care segments) in 1QFY09. This is higher by 175% YoY as compared to 1QFY08. This was mainly on account of steep increases in commodity prices and store rentals, the launch costs of the additions to the new Personal Care portfolio and the continuing brand building costs in the Foods business. Management has indicated of pursuing an aggressive expansion and brand building strategies. Most of the foods categories that ITC has entered in the past (atta, biscuits, snacking) have either been an entry segment or having small organised presence. ITC has done well in these segments to be among the top players in a short span of time. The sales of the division have grown by 120% over the last 6 years. However, its entry into consumer segment like shampoos, soaps and personal products is very competitive and strong players like HUL and P&G are well established. Though ITC will become a relevant player going forward, the cost of being a strong player would come at a higher price. Though the personal products business is likely to achieve scale and reduced launch expenses over the longer time, we don't see a breakeven in this division in the near future.

- **Downturn in cyclical businesses:** Both the paper and hotel industries are cyclical in nature. ITC has lined up expansion plans with 3 new hotels coming up in the next 2 to 3 years. In the paper segment, it is expanding capacities across segments. It is in the process of doubling pulp capacity, expanding the printing and writing paper segment and paperboard business over the next 2 years. However, both these are inherently cyclical in nature and could face a downturn if the economy were to slow down. In such a scenario, earnings growth could slow substantially and ROEs would also take a hit.

Investment rationale

- **Multi growth drivers:** ITC is moving in the right direction by de-risking its business model and entering new areas. ITC has successfully invested strong cash flows from its cigarette business into growth businesses such as hotels, food business and rural retailing. Strong cash flows (around Rs.20 bn) have earlier enabled ITC to establish a dominant position in the hotel and paper business. It has also successfully managed its various businesses to ensure that the firms ROE stays at a healthy 25%. We estimate a 16% CAGR growth in sales and a profit growth of 10% CAGR over the next 3 years. *(Refer Table 1on Page 7)*

- **Balance sheet to remain strong:** ITC is planning to pump in Rs.200 bn over the next five years in different businesses to scale up its operations. Except under extraordinary circumstances, we expect most of these investments to be taken care of by the company's strong internal accruals, thus putting little or no pressure on its balance sheet. This is likely to give the management enough confidence and flexibility to pursue various projects and not worry about them getting delayed due to financial constraints.

- **Cost benefits from synergies:** The company has planned its business model in such a way that most of its segments derive some synergy benefits and leverage upon the strengths of the existing segments. Matches and agarbati are value additions to its pulp business while stationery and greeting cards are the downstream verticals of the paper business. The branded apparel business has been built upon the brand building and supply chain management skills of the tobacco business and the service skills of the hotels business. The branded foods business has been built upon the brand building, supply chain management and distribution capabilities of the tobacco business, the culinary expertise of the hotels business and the agri-sourcing capability of the agri-business Division. Furthermore, the presence of the company is in segments, which have low penetration and good prospects. On account of these factors, the company is expected to reduce its dependence on the cigarette business from 58% of the revenues in FY08 to 52% in FY11.

Background

ITC is the largest cigarette company in India and has diversified into multiple businesses over the years. ITC commands around 80% of India's Rs 230 bn domestic cigarette market (value terms). Out of the top 10 cigarette brands in India, 6 belong to the ITC stable. The growing awareness of the harmful effects of tobacco has resulted in ITC focusing on de-risking its revenue profile (like any other international player in the last 25 years). Consequently, it merged the paperboards subsidiary with itself and invested in growing the hospitality, retailing, packaged foods and IT businesses.

The ITC group has emerged as the second largest luxury hotel chain after Indian Hotels. In packaged foods, its product range includes ready-to-eat (Kitchens of India), staples (Aashirvaad Atta and Salt), confectionery (Mint-O and Candyman) and biscuits. ITC has also entered into garment retailing. Other initiatives include greeting cards, safety matches and incense sticks. Last year, it entered into the snacks (with launch of Bingo) and personal care segments (soaps, shampoo). Also, it took the e-Choupal initiative to reach Indian villages where nearly two-thirds of the country's population lives. Started as a sourcing venture for ITC's non-cigarette FMCG business, e-Choupal is now undergoing transition to become a highly effective distribution channel and would be known as Choupal Sagar.

Comparative Parameters

FY08/CY07	ITC	GPI	HUL
Current price (Rs)	189	1,500	245
Market cap (US$ m)	17,807	386	13,337
Revenues (US$ m)	3,487	226	3,429
EBDITA margin (%)	31.6%	15.3%	13.7%
Net profit margin (%)	22.4%	12.4%	14.0%
Return on assets (%)	18.1%	13.4%	28.2%
Return on equity (%)	25.9%	22.4%	133.8%
Price to earnings (TTM, x)	23.1	15.1	27.3

Industry Prospects

The Indian tobacco industry is unlike most other countries. Inspite of being the second largest producer of tobacco in the world after China, it holds a meager 0.7% share of the US$ 30 bn global trade in tobacco, with cigarettes accounting for 85% of the country's total tobacco exports.

Chewing tobacco has been a tradition in India for centuries. Of the total amount of tobacco produced in the country, around 48% is in the form of chewing tobacco, 38% as bidis, and only 14% as cigarettes. Thus, bidis, snuff and chewing tobacco (such as gutka, khaini and zarda) form the bulk (86%) of India's total tobacco production. In the rest of the world, production of cigarettes is 90% of total production of tobacco related products. Per capita consumption of cigarettes in India is merely a tenth of the world average. This unique tobacco consumption pattern is a combination of tradition and more importantly, the tax imposed on cigarettes over the last 2 decades. Cigarette smokers pay almost 85% of the total tax revenues generated from tobacco. In India, three major cigarette players dominate the market, primarily ITC with 72% market share, Godfrey Phillips with 13% and VST with 8% share of the market.

The company is also present in hotels, paper, agri business and retail venture. The overall paper and paperboard industry in India is growing at around 7%; the value-added paperboard segment continues to grow at a substantially faster pace of around 20%. ITC offers products across different categories. The hospitality industry of the country is on a high growth path on account of huge upsurge in foreign tourist arrivals.

Currently, the size of the snack food market is estimated to be Rs 45 bn of which branded players account for Rs 20 bn. The snack food market is growing at 30% annually. ITC is eyeing a 25% share in this segment. It expanded its FMCG portfolio by staging an entry into the personal care market (market size Rs 200 bn), in an attempt to be the leading FMCG player in the country. It is introducing newer products in the segment and is making the required investments.

Risk Analysis

Please see 'Risk Matrix' table on page 6 of this report

Sector: We assign a medium rating to the company on this parameter as while close to 60% of its revenues come from the regulation intensive and high-risk cigarettes business, the remaining 40% comes from segments with great growth prospects like food, hotels and personal care.

Company standing: ITC has diversified interests across various sectors. Besides being a leader in cigarette business, it is gaining market share across its various other segments like paper, hotels and retailing. The company is moving in the right direction by de-risking its business model and entering new areas. ITC has successfully invested strong cash flows from its cigarette business into growth businesses. Some businesses are in high growth, while others require huge capex. We thus assign a medium rating on this parameter.

Sales: ITC has generated average revenues to the tune of nearly US$ 2.5 bn per annum in the past five years. In FY08, the company reported sales of US$ 3.5 bn. Given the growth prospects and company's strong presence and brands across segments, we believe that the company has the ability to grow its topline in double digits. We thus assign a low rating of 8 to the stock on this parameter.

Operating margin: Operating margin is a measurement of what proportion of a company's revenue is left over after paying for variable costs of production such as raw materials, wages, and sales and marketing costs. A healthy operating margin is required for a company to be able to pay for its fixed costs, such as interest on debt. The higher the margin, the better it is for the company as it indicates its operating efficiency. ITC's average operating margin for the past five years has been 34.1%. We expect the margins to be a 30% going forward on account of its new ventures and rising input prices. We thus assign a rating of 7 on this parameter.

Long term EPS growth: ITC has grown its net profits at a CAGR of 18% in the past five years. Though the growth will slowdown in the coming years on account of larger base and capex plan, double digit growth would still be witnessed. As such, the rating assigned to the stock on this factor is 5.

Return on capital invested (ROIC): ROIC is an important tool to assess a company's potential to be a quality investment by determining how well the management is able to allocate capital into its operations for future growth. A ROIC of above 15% is considered decent for companies that are in an expansionary phase. Considering ITC's last five years' average ROIC of 36.5% and projected average ROIC of 19.5% over the next three years, we have assigned a low-risk rating of 7 to the stock on this parameter.

Dividend payout: A stable dividend history inspires confidence in the management's intentions of rewarding shareholders. ITC's average payout ratio has been around 39% over the past 5 fiscals. We expect it to come down to 25% going forward on account of its strong capex plans, which is still decent. Thus, we have assigned a low-risk rating of 7.

Promoter holding: A larger share of promoter holding indicates the confidence of the people who run it. We believe that a greater than 40% promoter holding indicates safety for retail investors. At the end of June 2008, the promoter holding in ITC stood at 0%. We have hence assigned a high-risk rating of 1 to the stock.

FII holding: We believe that FII holding of greater than 25% can lead to high volatility in the stock price. The FII holding in ITC at the end of June 2008 stood at 13.5%. Based on our parameters, the rating assigned is 5.

Liquidity: The average daily trading volumes of ITC's stock over the past 52 weeks stand at over 11,07,729 shares. Such high liquidity level is a matter of comfort, as this might protect the stock from undue volatility in case of exchange of large holdings among market participants/investors. The rating assigned is 10.

Current ratio: ITC's average current ratio during the period FY04 to FY08 has been 1.4 times. This indicates that the company is comfortably placed to pay off its short-term obligations, which gives comfort to its lenders. We assign a medium-risk rating of 5.

Debt to equity ratio: A highly leveraged business is the first to get hit during times of economic downturn, as companies have to consistently pay interest costs, despite lower profitability. Considering ITC being a relatively debt free company we have assigned a low-risk rating of 10 to the stock.

Interest coverage ratio: It is used to determine how comfortably a company is placed in terms of payment of interest on outstanding debt. The interest coverage ratio is calculated by dividing a company's earnings before interest and taxes (EBIT) by its interest expense for a given period. The lower the ratio the greater is the risks. Inspite of ITC's interest coverage ratio reducing going forward (Given ITC's average interest coverage ratio of 460 times in the last 5 years, which we come down to 61 times by FY11), it is still strongly placed. We accord a low risk rating of 9 to the stock on this parameter.

P/E Ratio: The P/E ratio (price-to-earnings ratio) of a stock is a measure of the price paid for a share relative to the per share income or profit earned by the company. This is one of the important metrics to judge the attractiveness of a stock, and thus gets the highest weightage in our risk matrix. ITC's P/E on its 1QFY09 earnings stands at 23.1 times, which makes the stock fairly valued from a medium term perspective. As such, we have assigned a high risk rating of 1 to the stock on this parameter.

Considering the above analysis, the total ranking assigned to the company is 75 that, on a weighted basis, stands at 5.6. This makes the stock a medium-risk investment from a long-term perspective

Valuations

We had recommended a 'Buy' on ITC in Aug 2007 at Rs 161with a target price of Rs 224 from an FY10 perspective. Since then it has touched a high of Rs 231 and is currently trading at 17% premium to our recommended price.

We now recommend a 'Sell' on the stock with a target price of Rs 205 from an FY11 perspective. While all the segments of the company are adding value to its existing business, we believe that the sustainability of the high growth is at risk, at least in the medium term, on account of the concerns mentioned at the start of this report. Assigning an earnings multiple of 18 times to FY11 EPS of the company, we arrive at a target price of Rs 205, thus translating into a CAGR of 3% from the current levels.

Valuations

(Rs m)	FY08	FY09E	FY10E	FY11E
Net sales (Rs m)	139,475	164,381	188,640	216,205
Net profit (Rs m)	31,201	33,741	37,777	42,869
EPS (Rs)	8.3	9.0	10.0	11.4
Price to earnings (x)	22.9	21.1	18.9	16.6
Price to sales (x)	5.1	4.3	3.8	3.3
Price to B/ value (x)	5.9	4.9	4.2	3.5

BV=Book Value

Risk Matrix

		Rating accorded	
Rating	**Weightage* (A)**	**Rating# (B)**	**Weighted (A*B)**
Sector risk	-	Medium	NA
Company's standing	-	Medium	NA
Performance parameters			
Sales	5.0%	8	0.4
Operating margins	5.0%	7	0.4
Long term EPS growth	10.0%	5	0.5
Return on invested capital	10.0%	7	0.7
Technical parameters			
Dividend payout	5.0%	7	0.4
Promoter holding	10.0%	1	0.1
FII holding	5.0%	5	0.3
Liquidity	10.0%	10	1.0
Safety parameters			
Current ratio	5.0%	5	0.3
Debt to equity ratio	10.0%	10	1.0
Interest coverage ratio	5.0%	9	0.5
P/E ratio	20.0%	1	0.2
Final Rating**		**75**	**5.6**

Rating has been assigned on the basis of the company's performance over the past five years and expected performance over the next 3 to 5 years. Rating is on a scale of 1 to 10, with 1 indicating highest risk and 10 indicating lowest risk.

* 'Weightage' indicates the relative importance in percentage terms of the parameter. For instance, for an investor, given all the performance metrics, valuation (say P/E) should be the foremost criteria for buying/not buying stocks.

** The final rating has been arrived at by multiplying the rating/points given on each parameter with the respective weightage

ITC's growth drivers

Divsions	Dominance	Segment potential
Cigarette	80% in value terms and 72% in volume terms of the Rs 230 bn cigarette market size	In India only 14% is cigarette production, while in the rest of the world, production of cigarettes is 90% of total production of tobacco related products. Per capita consumption is 110 sticks per annum as compared to world average of 1,190 sticks.Bidi consumption is 600 sticks per annum presenting an upgrading potential as income rises. ITC will witness modest growth.
Paperboards/Packaging	Market leader across all carton-consuming segments including cigarettes, foods, beverages, pharma, personal care & toiletries, durables and match shells. ITC is the largest exporter of coated boards from India.	Per capita consumption in paper and paperboard is 7 kgs in India as compared to world avg. of 55 kgs. The overall paper and paperboard industry in India is growing at around 7%, the value-added paperboard segment continues to grow at a substantially faster pace of around 20%. ITC is expanding its capacities along with backward integration.Will see growth and profitability because of economic upturn and better product mix will help margins.
Hotels	2nd largest player in India	Demand supply gap in the hotel sector led by strong economic growth, strong tourist inflow and rising domestic travel. According to recent estimates of the WTTC (World Travel and Tourism Council), Indian tourism demand will grow at 8.8% CAGR over the nine years (2006-15), which would place India as the second most rapidly growing tourism market in the world. ITC expanding its room inventory to benefit from the strong demand. However, with new supply comnig in from other players, room rates will get rationalised
Agri business	India's second largest exporter of agri-products	Though a low margin business, ITC's agri-division offers three-way benefits to the company - procurement of raw material at lesser cost through e-Choupal, commission through trading of agri-commodities and selling FMCG products through Choupal Sagar stores.
FMCG	2nd largest agarbati player with 5% market share, No 1 player with 7.5% market share in stationery segment, 12% market share in biscuits, 54% market share in atta segment 48% market share in RTE, No 1 in the confectionery segment, 16% market share with launch of Bingo.	**Market size :** Rs 1.2 bn agarbati market , Rs 2.2 bn stationery market, Rs 80 bn bicuits market, Rs 12 bn branded atta market Rs 800 m ready to eat market (RTE) Rs 20 bn confectionery market Rs 20 bn snack market Rs 200 bn personal care market Foods is believed to be the next sunrise sector worth Rs 600 bn with biscuits and snacks valued at Rs 100 bn in the next 2 to 3 years. While ITC will face competition, its strong brands, procurement and distibution system will aid its growth.Rising income, lower penetration, growth of modern retail and consumerism will drive the segment (growing at 10%pa). Though ITC wil lbecome a relevant player, it will take time to breakeven.

Financials at a glance

(Rs m)	FY08	FY09E	FY10E	FY11E
Sales	139,475	164,381	188,640	216,205
Sales growth (%)	12.8%	17.9%	14.8%	14.6%
Operating profit	44,039	50,612	58,240	67,035
Operating profit margin (%)	31.6%	30.8%	30.9%	31.0%
Net profit	31,201	33,741	37,777	42,869
Net profit margin (%)	22.4%	20.5%	20.0%	19.8%
No of shares	3,769	3,769	3,769	3,769
EPS	8.3	9.0	10.0	11.4
Balance Sheet				
Net fixed assets	72,956	111,370	147,581	181,590
Current assets	70,192	67,867	78,207	86,397
Investments	29,346	29,346	29,346	29,346
Total assets	**172,494**	**208,583**	**255,133**	**297,332**
Current liabilities	49,774	51,134	57,957	65,826
Net worth	120,577	144,449	171,176	201,506
Total debt	2,144	13,000	26,000	30,000
Total liabilities	**172,494**	**208,583**	**255,133**	**297,332**